UniCredit Group

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UniCredit Group's reply to the BCBS proposal on LOSS ABSORBENCY CAPACITY at the POINT of NON-VIABILITY

GENERAL REMARKS

We support the concrete attempt by the BCBS to address moral hazard concerns. The proposal indeed has some merits however UniCredit strongly believes that should be maintained a **clear distinction between Tier 2 (i.e. "gone concern" capital) and Tier I (i.e. "going concern" capital)**:

1) **Tier 2 instruments** should absorb losses only in a gone concern scenario as defined by the applicable legislation, as the extraordinary administration which may be followed by liquidation. As a notable example under the Italian Banking Act coupons suspension and reimbursement deferral are possible under Extraordinary Administration while the permanent write-off only in liquidation. Loss absorbency before this phase should be considered only in the context of the broader reform of the bank resolution framework at EU level. In fact a public declaration of "non-viability" without the possibility to put in place a credible action plan for the complete "return to viability" by the public authority(-ies) is likely to be interpreted by the market participants, including retail depositors and investors, as an event of a default, with all the related undesirable consequences. Should BCBS proposal be applied to Tier 2 anyway, the impact on Tier 2 instruments would be such that a market is very likely to disappear. In such case it would be much better to simply derecognise Tier 2 and to require only Core Tier I and Tier I ratios.

2) Regarding the loss absorbency of **non-core Tier I instruments** the following is noted:

   a. In order to allow the market viability of these instruments the trigger event that defines "the non-viability" should be more clearly and objectively identified. We suggest automatic triggers on variables related to regulatory capital ratios. The trigger levels should be autonomously set by the bank above the regulatory minimum. As already stated for Tier 2 instruments, any declaration by authorities may be interpreted as an event of the default by the market, while the use of market variables (e.g. CDS price) would

presently generate hardly predictable incentive to speculate against the viability of the bank.

b. Among the two alternatives for loss absorption, **conversion into equity** is more realistic and logical from a market perspective since it maintains a clear subordination structure and an upside potential for Tier I holders at least equal to ordinary shareholders. In any case, implementing any of the two solutions requires significant changes to the existing Italian fiscal and legal frameworks as detailed in paragraph 2b below.

1) TIER 2 INSTRUMENTS

a) We believe it is counter-productive to assume that systemically relevant banks can not go into liquidation and there is no orderly resolution regime. The risk may be relatively low and properly addressed also through regulatory requirements, however neither from a regulatory point of view nor from a corporate perspective we can exclude it. Hence, outstanding Tier 2 instruments do remain an acceptable gone concern instrument.

b) In the case of a trigger event, the holders of this instrument would find themselves worse off than the old equity holders, as the latter could at least benefit from potential future capital gains. Seniority should be preserved, otherwise the pricing of the instrument could make it more expensive than equity.

c) While the proposed features might be acceptable for Tier I instruments, there would not be a sufficient market to absorb the overall needs for Tier 2 instruments should they become a going concern instrument.

2a) THE "NON VIABILITY" TRIGGER

The proposal seems workable in many aspects and it is complementary to other reforms in the resolution framework which are needed at cross-border level and in the EU.

However, we have two major concerns:

i) the fact that **the point of "non-viability" is not clearly defined** and the **full discretion left** to the relevant authority when defining the trigger event in going concern leaves it open to different interpretation across different jurisdictions and, when combined with ii) the request for a permanent write-off/conversion, it will make it practically **impossible** for investors **to price the conversion risk** associated to the instrument.

2a i) clear definition of the of "non-viability" point

We understand that the primary objective of the BCBS proposal is not the financial stability of banks, but it is rather to manage moral hazard issues to ensure that regulatory capital holders (of systemic banks) do absorb the losses. We also understand that the BCBS suggests that the definition of gone-concern (arising from capital or liquidity problems) can be "put forward" just before the threshold is overcome[1].

UniCredit believes that according to the BCBS proposal, the point of "non viability" trigger in going concern is not clearly defined. **We would rather suggest to use as trigger the capital deficiency event**, linked to the equity amount ion the balance sheet or to regulatory ratios validated by competent authorities, rather than, as proposed by BCBS, having the "declaration of non-viability" by the public authority-ies.

2a ii) full trigger discretion would make pricing very difficult

In addition to financial stability and level playing fields considerations, this is also very important in order to try to maintain smooth market conditions. A fully discretionary decision by the relevant authority for the trigger event would make it practically impossible to price this instrument which *inter alia* requires the assessment of the probability of intervention by the authority.

If, in the end for political reasons, **a statutory approach** is chosen for a going concern, with the public declaration by the national authority, **effective coordination between authorities is crucial well before the public declaration.**

Bearing in mind cost and market concerns, we would see four additional pre-conditions, which are aimed at managing the financial stability and level playing field concerns, as well as allowing the development of a market (where at minimum the financial instrument could be priced due to better risk measurement):

- that the **management and timeframe of the conversion/write off** is such that financial stability is preserved and, if needed, includes a short moratorium period, to facilitate and assist the agreement among the relevant capital instrument holders;
- a subsequent **public declaration** by the same competent authority(-ies) **of restored "viability"**;

[1] BCBS states: "situations in which the public sector provides support to distressed banks that would otherwise have failed".

- BCBS to provide, in close cooperation with the CEBS and the European Systemic Risk Board when relevant, a **common risk assessment framework** that will be used by the competent authorities to avoid uncoordinated decisions based on an incomplete set of information on the systemic consequences;
- an effective **mechanism for cross-border cooperation** should be in place.

2b) ISSUES TO BE ADDRESSED IN THE ITALIAN FISCAL AND LEGAL FRAMEWORK

The proposal to review non-core Tier I instruments implies legislative and regulatory changes addressing existing resolvable obstacles in the legal and fiscal frameworks.

Between the permanent write-off and the conversion into equity approach, **we prefer conversion**. This is based upon (i) the necessity to maintain an upside potential for Tier I holders at least equal to ordinary shareholders and (ii) pricing and market capacity considerations.

A **special new legal regime** (at least in countries such as Italy) seems necessary to ensure *inter alia* **flexibility for the issuer on the modalities and timeframe** of the capital increase, derogating ordinary laws on:

- the high quorum necessary in Italy for non-preemptive rights issue delegated to the Board of Directors: since subordinated instruments are typically placed to institutional investors (rather then to shareholders), the rights issue must be approved by a very high quorum in the Annual General Meeting (50%+1 of the share capital), which is difficult to achieve for listed, large banks with a fractioned ownership;
- the maximum tenor for the necessary authorizations under the applicable company law or company by-laws to issue these instruments must be compatible with the maturity of the new instruments, being perpetuals.

In addition, in order to avoid the constraints about the maximum number of shares issuable, the minimum conversion price should be fixed at inception with sufficient flexibility given to the issuer regarding the modalities and timeframe for its determination.

From a tax point of view, the inclusion of a permanent write-off and/or conversion features may have a detrimental effect both for the issuer and for the investor in a way that the instrument is likely to become less attractive.

In particular, the proposal might have a major impact affecting, in principle, several aspects such as (i) the qualification of the instrument for accounting and tax purposes, (ii) the

deductibility regime of coupons paid on the instrument and (iii) the determination of the applicable withholding tax.

PART2: Specific comments and answers

Question I Would the development of effective bank resolution schemes be a better approach to ensuring gone-concern loss absorbency?

Answer: We share the arguments provided in the reply. In particular, we fully agree with the long-term objective of a global bank resolution framework where Tier 2 remain a gone concern tool.

Question 2 Would it be simpler to de-recognise Tier 2?

Answer*:* It is clear that the put option embedded in the instruments (if conversion price is fixed at inception) will be based on the market perception of the likelihood of public intervention. The stronger the market's perception of probable public intervention, the more expensive the put option would be. Thus, the coupon demanded would be higher. The cost of Tier 2 would be closer to that of TI, making it uneconomical for banks. At this point, it would be much better to simply derecognise Tier 2 and to require only Core Tier I and Tier I ratios.

Question 3 Will this not impose unnecessary costs on small banks?

Answer*:*

We believe that including conversion / permanent write-off features in Tier I and Tier 2 instruments would not only impose unnecessary costs on small banks, but rather on the overall banking industry. In such case, maintaining both Tier I and Tier 2 ratios does not make sense (see above).

Question 4 Would the proposal change the investor base?

Answer

This is certainly true for Tier 2 but not for Tier I instruments. Hence, the proposal's intention to make Tier 2 instruments loss absorbing in going concern would simply have the effect of making Tier 2 instruments very similar to Tier I.

Investors in Tier 2 instruments are very different from those investing in Tier I. Making Tier 2 instruments more similar to Tier I would dramatically restrict the investor base.

Question 5 What if the holders of the capital instruments are not permitted to own shares in the bank?

Answer

Many investors are restricted from holding shares or instruments which, if converted, would result in potentially large holdings of bank shares. As said above, the proposal of a conversion / permanent write-off, if implemented, would have the effect of significantly restricting the investor base: fixed income investors typically investing in Lower Tier 2s will not / could not invest in equity-like instruments and this would generate a massive capacity issue for the industry.

Question 6 Would it be better to have an automatic trigger for conversion/write-off linked to some market variable or regulatory ratio?

Answer:

The proposal to make Tier I and Tier 2 loss absorbing at a trigger point can be considered as a put option that investors would grant to the regulators to intervene and either write-off or convert their bonds into equity.

In the current proposal, this intervention appears to be totally discretionary: the perception of "non-viability" may also well vary from regulator to regulator and country to country. This would clearly be counter to what UniCredit has always fostered: the creation of a level playing field in Europe and globally.

We believe that an automatic trigger for conversion/write-off would give much more clarity to all market participants and would be a step in the right direction with regard to the level playing field.

Such a trigger should be linked to regulatory ratios rather than market variables: this is because, as said in the paper, no-one knows what future crises will look like and it is difficult to set market variables based on the today's experience in order to face tomorrow's crisis: 100 bps of 5y CDS may have seemed an appropriate trigger just a few years ago, while today it would be considered as far too low. In addition, market variables are overly exposed, by definition, to the market and to speculation: an ailing bank may be pushed into non-viability by speculators who short the relevant market variables and hence accelerate breaching the trigger.

On the other hand, a variable based on equity amount in the balance sheet or a regulatory ratio based on either capital - e.g. capital deficiency event as defined by the regulator - would guarantee transparency and efficiency.

Question 7 How would the approach apply to capital issued out of subsidiaries, could this not lead to the break up of a group?

Answer

Yes, the conversion into equity of instruments issued out of a subsidiary would dilute the equity stake in that subsidiary, potentially resulting in de-consolidation and/or loss of control. However, UniCredit believes that if it is guaranteed a sufficient level of flexibility to the issuer in defining the equity-conversion feature, this would be regarded as a manageable risk.

Question 8 Would we not be transferring the problem of a failing institution to the insurance companies and pension fund sectors that hold the bank capital?

Answer

That is a major risk hidden in the proposal: the write-off at a high percentage of bank capital would risk impacting on the insurance companies/pension funds which hold the bank's capital. However, this should be dealt with the appropriate regulatory treatment of such instruments for the purposes of insurance companies solvency capital. In more general terms, many insurance companies will no longer be allowed to invest in the new Tier 2 instruments and hence the capacity will be significantly reduced.

Question 9 How can we be sure that the conversion/write-off is not considered a default?

Answer: We are concerned that the declaration of non-viability (without additional public or private financial resources) by the competent authority(-ies) will be interpreted *de jure* or *de facto* as a credit event. Such a default interpretation by the market will have financial stability consequences. It is indeed hard to imagine that a permanent writer-off of a debt instrument does not constitute an event of default. A situation where the bank capital instruments are converted into equity would be different: convertible bonds already exist in the corporate world which could be replicated in the banking world.

Question 10 Does conversion/write-off improve loss absorbency even though it does not bring in new money?

Answer*:* The conversion into equity, if there is set a pre-determined maximum number of share, will definitely improve the loss absorbing capacity of the banks, because the conversion effectively creates capital which can be used to offset losses

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