

19 June 2013

**UniCredit reply to BCBS on
“Recognising the Cost of Credit Protection Purchased”**

UniCredit is a major international financial institution with strong roots in 22 European countries, active in approximately 50 markets, with about 9.500 branches and more than 155.000 employees. UniCredit is among the top market players in Italy, Austria, Poland and Germany. In the CEE region, UniCredit operates the largest international banking network with around 4.000 branches and outlets, and is a market leader.

Executive Summary

UniCredit supports the efforts of the BCBS to establish a sound framework for the cost recognition of transferring risk via credit protection arrangements, however **UniCredit challenges the fundamental need for BCBS to distinguish between “material” and immaterial risk transfer and premia levels.** In fact, UniCredit contends that a simplified approach involving Pillar 2 supervision and incorporating no such distinctions would be more effective, require less interpretation by local regulators and reduce potential opportunities for further “arbitrage.”

UniCredit view is that a transfer of risk (in any amount and at any price) is simply the exchange of a specific exposure by one entity for another exposure involving protection from a third-party for some portion of the original risk. The primary challenges are to properly assess the value, the risk(s) and the appropriate regulatory treatment of the purchased protection. In the case of a synthetic risk transfer - where some forms of “immateriality” might be perceived by the BCBS - the new risk profile incorporates an exposure to a counterparty which should be valued similarly to any other new exposure involving a “material” extension of credit to such counterparty.

The exceptions to this approach (and, from UniCredit perspective, the primary target of the BCBS proposed framework) are situations in which a) the premium paid for the credit protection is “guaranteed” by the purchaser of the protection regardless of the performance of the reference (or transferred) exposure or b) the premium paid is excessively high relatively to the actual transferred risk. In these situations, the premium leg of the purchased protection represents either an unconditional obligation of the credit purchaser or excess premia paid. In both cases, such premia should be valued through an appropriate valuation mechanism which would then be applied against the value of the protection. The capital attributable to the new position (net of the guaranteed or excess premia) should reflect the risk weighting of the counterparty.

Against this background, **UniCredit suggests** that:

1) the **BCBS proposals should exclude standard single-name CDS** given a) the fact that the perceived and targeted arbitrage opportunities are primarily asset pools rather than single name exposures and b) that imposing such restrictions on single-name CDS would produce direct inconsistencies between the treatment of CDS in banking and trading books. In fact, the proposed approach effectively imposes a capital regime for credit hedges outside of the trading book in which premia qualify as material that is relatively more restrictive than that currently imposed on CDS hedges in the trading book. In other words, for trading book positions, CDS hedges are captured within counterparty credit RWA with the calculation incorporating expected exposure and defined PD and LGD parameters.

2) the **BCBS should consider these new proposals in light of the on-going consultations regarding the revisions to the “Securitisation Framework”**. Specifically, the securitization regulatory framework, in its current form, would already significantly reduce the capital benefits of risk transfer of securitization exposures and, correspondingly, would already address potential interbank capital arbitrage opportunities. **The cumulative effect on the real economy should also be adequately considered in order to avoid** likely unintended consequences on the securitization as a useful funding technique. Transferring risk through funded securitizations is increasingly difficult in light of the proposed BCBS Securitisation Framework. These proposed restrictions, when combined with the new ones proposed by the BCBS in this Consultative Document, **form a prohibitively limiting environment for transferring risk particularly relating to certain asset classes in which market-driven alternatives for transferring risk are currently unavailable (such as SME loans)**.

3) the **BCBS should properly address “level playing field “concerns** also because in its current form would allow national discretion on several important factors, such as the scope (e.g. the definition of “high risk”) and key parameters (discount rates, spread income, Loss Given Default, maturity mismatches etc.).

4) the BCBS should confirm the non-**retroactive applicability** since it remains unclear whether and if the proposed rule would be retroactively applicable to already existing securitization transaction.

5) the BCBS should confirm that hedges related to trading book assets and banking book assets carried at fair value are not intended to be covered by the proposed revisions to 189(a) and 189 (b).

6) is necessary to adequately consider the **unintended consequences affecting recent financial innovations developed in the aftermath of the financial crisis, aimed at restoring SME financing**. In this regard, UniCredit has performed a number of synthetic securitization transactions labeled, according also to Italian legislation, “*Tranched Cover*” in which the upfront junior protection was provided by a regional, national or a supranational entity for the construction of a tailored loan portfolio according to a set of mutually pre-agreed criteria. As a result of this innovative origination structure, loans granted under these initiatives benefited in terms of discounted pricing with respect to standard market rates and helped the real

economy in terms of liquidity and better access to financing in a difficult economic environment. Having in mind the importance of enhanced access to finance, - especially in certain large economic areas that have been struggling for years with a particularly adverse economic environment, potential introduction of the framework presented in the BCBS consultation paper would endanger the possibility of continuing benefits derived from these initiatives.

Replies to individual answers

***Q1.** In addition to the 150% risk-weight threshold, should additional exemptions for certain types of transactions be considered? In particular, the Committee welcomes feedback on (1) exposures guaranteed by governmental entities (including sovereigns and public sector entities) and (2) trade finance transactions with guarantees.*

UniCredit views the 150% risk-weight threshold as arbitrary and that the materiality of premia level should not be based solely on the risk-weighting of the relevant underlying asset. Rather, the goal of the BCBS proposed framework should be, in UniCredit opinion, to ensure that risk premia levels are commensurate with the actual risk transferred so that distortions do not occur in which excessively high premia (particularly “guaranteed” premia) are applied against relatively small amounts of transferred risk. Such distortion can occur regardless of the risk-weighting of the relevant transferred risk and, therefore, a less prescriptive approach may be more applicable.

While UniCredit fails to see the relevance of an initial risk-weighting of 150% as the determinant of material risk and/or risk transfer, government and public entity guarantees should reflect the risk-weighting of the guarantors. This should, in fact, be the consistent treatment for other credit protection providers as well.

However, should competent regulatory authorities require compulsory implementation of an absolute risk-weighting, UniCredit feels this risk-weighting should not be based on the initial risk-weighting but on the average expected risk weighting. Since the risk-weighting is a function of time, decreasing maturities inevitably lead to decreasing risk-weightings.

Furthermore, UniCredit considers that the impact of the proposals within the BCBS consultation paper would clearly limit the ability of banks to manage portfolio risk, leading to distorted incentives. Specifically:

- the proposals would increase the costs for banks to hedge higher risk exposures, either by single name CDS or through more complex structures, potentially reducing the capabilities of banks to offer loans to customers, e.g. if hedging SME loans via risk transfer structures become more punitive.
- Transferring risk through funded securitizations are increasingly difficult, particularly in light of the proposed BCBS Securitisation Framework. These proposed restrictions, when combined with those proposed by the BCBS in this Consultative Document, form a **prohibitively limiting environment for transferring risk particularly relating to certain asset classes in which market-driven options for transferring risk are currently unavailable (such as SME loans). If implemented, the proposed BCBS Securitisation Framework would also increase the universe of risks qualifying for material premia definition since the framework would increase the risk weightings of a broad range of securitisation exposures.**
- The proposals would also unnecessarily skew the ability of banks to manage portfolio risk towards hedging better (lower risk-weighted) risk and create disincentives for hedging higher risk weighted

exposures. See the below example utilising a pre-hedge 4-year term corporate loan exposure (rated B+) with an RWA of 159.42% and a four-year CDS spread of 300 bps:

Present Value of Carry Payment (based on a risk-free rate of 2%)

Year	Carry in %	Present Value
0		
1	3.00	2,941
2	3.00	2,884
3	3.00	2,827
4	3.00	2,772
Sum PV carry		11,423

**RWA Simulation
(0% RW of Hedge Counterpart)**

Hedge Notional	100
RWA before protection	159,42
RWA after protection (0%RW) - currently	0,00
RWA after protection (0%RW) + new rule (11,4*1250%)	142,79
RWA relief	16,63

**RWA Simulation
(20% RW of Hedge Counterpart)**

Hedge Notional	100
RWA before protection	159,42
RWA after protection (20%RW) - currently	20,00
RWA after protection (20%RW) + new rule (11,4*1250%)	162,79
RWA relief	-3,37

This example illustrates that, for certain exposures and assumptions, the proposed methods of recognizing the costs of credit protection can either dramatically reduce or completely eliminate the economic benefits of hedging even with relatively low risk-weighted counterparties / guarantors.

Q2: *The Committee welcomes feedback on all aspects of the proposed changes to the rules text and the supplementary technical guidance.*

Capital Deduction of Risk Premia (§189b) – Consistent with the above comments, capital deduction should only be applied to risk premia which are unconditionally guaranteed by the purchaser or which are clearly excessive relative to the amount of risk transferred (or, in other words, effectively guaranteed by the nature of the premia level and structure). Guaranteed premia should be defined as obligations of the protection purchaser regardless of defaults, redemption payments and other events while “excessive premia” should be defined based on a ratio of annual premia over notional amount of protected asset. Conversely, the difficulty in defining “excessive” highlights the potential benefits of a more principal based approach.

In addition, UniCredit deems it appropriate to explicitly state that banks acting as - inter alia - sponsors of ABCP programs, which benefit from guarantees or credit derivatives (e.g. credit insurance), should not be required to take into account any costs for such credit protection.

PV of the Material Credit Protection Cost / Maturity Mismatch - A 1250% risk-weight must be assigned, according to the BCBS proposal, to the PV of the cost of protection for assets with a risk-weighting in excess of the 150% materiality threshold. This implies that two distinct exposures will be reported to the regulatory authorities including the newly “protected” portfolio and the PV of the material premia.

The following summarises Example 3 – Transaction C, Option 2 incorporating a risky discount rate (page 11):

- a. RWA before securitisation: 200
- b. RWA after securitisation: $90 \times 7\% = 6.3$
- c. RWA Risky PV premium: $5.73 \times 1250\%$

The RWA at (a) and (b) are “point in time” measures based (among other factors) on one year PD, one year LGD and maturity of the loan (max 5 years). The PV of the premia (c), however:

- is based on defaults, prepayments and recovery assumptions typically utilised in multi-period portfolio simulations; and
- incorporates payments usually to maturity of the credit protection (therefore, often longer than 5 years for maturity matched protection).

According to the above, if the exposure (c) has to be considered, it should be calculated in a comparable way to the amount of the exposures as per point (a) and (b). Therefore, for protection/securitisations with maturities longer than 5 years the cost of protection must refer to a 5 year time horizon maximum. (*This calculation is performed periodically over the life of the transaction*).

Contingent vs. Guaranteed Premia - Although the BCBS consultative paper mentions various conditions under which premia should be considered contingent or non-contingent, these conditions should clearly state that premia/spreads on securitisations or purchased credit protection are contingent cases in which the on-going premia payments are directly linked to the outstanding nominal amount of such securitised or credit protected exposures (excluding “excessive” premia).

In addition, the determination and application of the risky discounting rate and methodology should be clearly defined and not subject to local regulatory interpretation.

The BCBS should also recognize, in its definitional framework relating to the operational requirements for guarantees and credit derivatives, that such contracts may incorporate provisions allowing for termination for events unrelated to credit such as fraud, misrepresentation and illegality.

Significant Risk Transfer Calculation - The risk premia should not have any effect on the risk transfer calculation as this would add unnecessary complexity to the process and, correspondingly, must not impact the marketability of the financial instrument utilised for such risk transfer. In particular, unintended asymmetry could arise between financial institutions applying the advanced methodologies for the assessment of the Significant Credit Risk Transfer and those institutions utilising standard mechanistic tests (e.g. test on mezzanine).

In an effort to better clarify the impacts of the proposed approaches, UniCredit performed the below mentioned **quantitative exercise** on the basis of the structure of an actual deal. While the risk transfer evaluation computed via the regulatory approach utilising the so called “mezzanine criteria” would not be negatively affected by the addition of risk premia, the application of an internal methodology, as it is the case for UniCredit, could be significantly impacted. At the same time it must be considered that, even if a regulatory approach is applied, the introduction of the risk premia would affect the cap between the regulatory capital absorption of the underlying portfolio before the securitization and the capital requirement absorption after the securitization because the risk premia will cause the latter to dramatically increase and make the securitization technique inefficient in assessing the appropriate release regulatory capital.

UniCredit is currently associating an internal methodology that reinforces what comes up from the proposed regulatory approach. The table below summarised the quantitative exercise:

Quantitative exercise - figures summary							
discount rate	RWA relief pre risk premia	RWA add-on due to risk premia	new RWA relief	old Value at Risk transferred	new Value at Risk transferred	old Probability to incur in unexpected losses trasferred	new Probability to incur in unexpected losses transferred
11%	287.9	-409.11	0	43.04%	39.64%	91.85%	0.00%
3%	287.9	-585.28	0	43.04%	32.60%	91.85%	0.00%
15%	287.9	-350.8	0	43.04%	39.64%	91.85%	0.00%

The 3% discount rate represents a proxy of the risk free rate, while the 11% and 15 % respectively represent a rate lower and higher than the UniCredit Group Cost of Capital. These rates have been used to calculate the discounted value of the future cash outflows derived from the various hedging solutions. The future cash outflows represent a percentage of the outstanding of the junior tranche (on average equal to 3.70% of the junior outstanding amount during the transaction lifetime). The discounted amount has been then applied in the risk transfer model as a super-junior tranche, according to what is stated in the consultation paper.

On the basis of the above quantitative test, it is clear that the application of the internal risk transfer methodology is significantly impacted and that, the theoretical transaction under analysis would be no longer effective from a risk transfer point of view following the inclusion of the discounted value of the risk premia. In fact, the computational result is that the RWA relief becomes equal to 0. In addition, the values of the risk transfer indicators become no longer compliant with the minimum requirements that UniCredit has fixed internally as the thresholds to be applied in valuing the risk transfer effectiveness of the transaction. This internal methodology has been developed as a more sophisticated test that allows UniCredit (an IRB bank) to analyse also the most complex transactions, always respecting the mandatory requirements as defined within Bank of Italy rules (Circular 263/10).

UniCredit fails to see any rationale in considering the credit risk premia in the assessment of the risk transfer especially if the material premia will be considered as an additional exposure for the financial institution resulting in no RWA reduction for that amount (ref. new §189a BCBS proposal).

Maturity Mismatches – UniCredit's general view is that the introduction is that Approach 1, as detailed on page 20 of the BCBS consultative document, is sufficient and that the introduction of an additional adjustment is unnecessary given the maturity mismatch provisions already included in paragraph 205.

In any case, the alternative approaches proposed are questionable. In particular:

Approach 2: This approach envisages an additional mechanic to compute a dummy RWA of the implied premia relating to the mismatched exposure. Approach 2 will imply:

1. the introduction of unnecessary complexity which is not appropriate for the securitisation structures, and
2. the application of an inconsistent methodology to compute maturity mismatch penalties in addition to the pre-existing method.

Approach 3: Again, UniCredit challenges the 150% threshold and views it as arbitrary and ineffective in defining transactions intended to be targeted by the BCBS proposal. Therefore, the application of Approach 3 to risk transfer transactions meeting the 150% materiality threshold unnecessarily creates a two-tier mechanism for calculating risk transfer effectiveness for situations in which a mismatch exists between protection and exposure.

In addition, Approach 3, to be coherent, must equally remove the five year cap for both protection and exposure in the risk transfer calculation. Therefore, the RWA reduction of the exposure, stemming from the new calculation of the maturity mismatch, should be compensated by the higher RWA to be accounted for that exposure on an equivalent basis.

Single Name CDS - As noted above, UniCredit fails to see the necessity of incorporating single name CDS in the proposed framework since “RWA arbitrage” opportunities are difficult to identify. This view is based upon the following:

- adequate and timely cost demonstration over time of single name hedges;
- proposed implication of PV of carry cost would inadequately increase cost of hedge at the beginning of a hedge life where the probability of default is lowest;
- no misalignment between recognition of loan income and hedge cost.

Recognising Spread Income – UniCredit agrees with those competent authorities that conclude that spread income should be taken into account in any required contingent premia PV calculation. Correspondingly, for guaranteed premia, the discounting calculations for spread income and premia should reflect risky discounting for the spread income and an “own-issue” discounting of the premia. Therefore, UniCredit considers Option (i) under Section 1.2 as the most reasonable approach to recognizing spread income subject to some definitional clarity.

In fact, an assumption of no available spread income would correspond with a complete portfolio default which would imply an unrealistically high portfolio risk profile and, therefore, a greater benefit to be recognised and accounted for by the credit risk protection purchased (e.g. greater RWA released).

Securitised Portfolio Spread Income - The Securitised Portfolio Spread Income for the amount reasonably estimated according to portfolio performance should always be taken into account. Even if the structure foresees a guaranteed premia, there should be an alignment of:

- the amount of spread income available according to the portfolio risk profile, and
- the portfolio exposure estimated according to the portfolio risk profile.

Level Playing Field Concerns – With respect to all points previously raised in this document, UniCredit’s general view is that the proposed guidelines do not completely address the necessity of a level playing field on an international level and that the acceptance of the proposal in its current form would allow national regulators to choose different approaches on a high number of important factors. In particular, issues subject to national discretion would include:

1. The definition of the “high risk” transaction to which the rule would apply,
2. Whether and when to allow the use of “risky” instead of “risk free” discount rates,
3. Selection of the “risk free” discount rate and the approach to determining the “risky” discount rate,
4. Whether to recognize spread income in all, some or no cases,
5. Setting of LGD and E(CPR) inputs; and
6. Treatment of maturity mismatches.

Retroactive Applicability – The BCBS should explicitly state that there is no retroactive application. From the proposed text it remains unclear whether and if the proposed rule would be retroactively applicable to already existing securitization transaction.

Client Pricing Concerns (New Origination Transactions) – In recent years, UniCredit has performed a number of synthetic securitization transactions labeled “Tranched Cover” in which the upfront junior protection was provided by a regional, national or a supranational entity for the construction of a tailored loan portfolio according to a set of mutually pre-agreed criteria. As a result of this innovative origination structure, loans granted under these initiatives benefited in terms of discounted pricing with respect to standard market rates and helped the real economy in terms of liquidity and better access to finance in a difficult economic environment. Having in mind the importance of enhanced access to finance, the potential introduction of the framework proposed by the BCBS consultation paper would endanger the possibility of offering pricing benefits under this type of transactions. In fact, setting aside additional capital for the credit protection paid under Tranched Cover operations for new origination, is very likely to imply that the pricing benefit to the client is lost.

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Please find below the list of the key people involved in this work, whose contribution made possible to coordinate and provide UniCredit answers to this Consultation. Some other experts have been involved alongside the UniCredit Group, but are not listed below.

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