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Unicredit reply to BCBS discussion paper on "The regulatory framework: balancing risk sensitivity, simplicity and comparability"

UniCredit is a major international financial institution with strong roots in ca. 20 European countries, active in approximately 50 markets, with more than 9.000 branches and ca. 150.000 employees. UniCredit is among the top market players in Italy, Austria, Poland, CEE and Germany.

Executive Summary

Internal models of risks calculation (IRB) are subject to severe scrutiny because of the differences amongst banks risk weighted assets (RWAs) calculations, both in banking and trading book.

Most European banks use IRB models to assess their risky assets but these appear to vary considerably, even when applied to similar portfolios. **These divergences lead both the IRB models and the RWAs to be perceived as highly subjective, making harder to compare capital ratios across banks**, both at cross-border and national levels.

In its consultation paper, BCBS reports a list of the observed differences in RWAs**, suggesting potential ideas to improve simplicity and comparability of bank capital ratios and outcomes**.
The divergences may be classified into two broad categories:

- Inconsistencies due to external factors : relating to differences between jurisdictions, often cited as 'level playing-field' issues, in legislation on the financial sector, financial accounting regimes and national and supervisory practices.
- Inconsistencies due to internal factors: relating to a bank's business model and approach to risk management, including notably the nature of internal models, and generally specific to individual institutions.

The BCBS, despite accepting that the use of the Basel models (Internal Rating Based (IRB), Advanced Measurement Approach (AMA) and Internal Measurement Approach (IMA)) brings overall more benefits than costs, raises concerns over these differences in banks' RWAs assessment and evaluation, suggesting the possibility to use more simple, standardized and non-risk-based approaches.

UniCredit agrees with the BCBS that the use of IRB models brings overall more benefits, by allowing for a better risk management and for a more adequate representation of the risk taken by a bank. However, **it would neither be easy nor desirable to eliminate all differences(related to internal factors**) across banks in the evaluation of their clients or portfolios because it would greatly increase systemic risk [1]. The use of internal models, by definition, makes required capital more **risk sensitive** and, therefore, helps to support financial stability**.** Moreover, internal models foster the development of sound internal processes and methodologies to identify, measure and address risks as i) IRB systems are crucial to the analysis of credit risk (i.e. selective lending policies); ii) IRB parameters quantify credit quality beyond traditional measures (e.g. non-performing loans ratios, cost of credit provisions). This makes it **easier and simpler** for risk managers to monitor credit quality trends, enhancing the capacity to anticipate credit quality deterioration, which would not be possible without these models; **iii) Internal models' capacity to quantify expected loss enables banks to quantify credit loss provisions in a more objective way**. In this sense, IRB models play a key role, not only to determine the required minimum capital, but also to

[1] Note that the use of public credit ratings prior to the financial crisis for many products accentuated the problems faced. In addition, using same risk management systems, models and methodologies would substantially increase the risk of herding behavior and therefore of systemic risk.

quantify in a more robust way **credit impairment provisions** which, after gross income, constitute the second line of defense against credit losses.

UniCredit agrees that disclosure under Pillar III, in its current form, does not adequately meet the need of RWAs comparability by investors. We believe it remains crucial to restore market trust in RWAs and to provide investors with a more granular information which eventually allow them to distinguish between RWAs differences due to a sounder risk management or to unjustifiable differences in risk assessment. To this end, **UniCredit welcomes the recent decision to establish a working group to review Pillar 3** with the objective to enhance disclosure and boost the comparability of Basel capital standards (Financial Stability Board, Enhanced Disclosure Task Force, The risk disclosure of banks, 29 October 2012).
In this regard, **UniCredit strongly believes that an enhanced disclosure would provide an efficient way to address IRB models differences**, by linking the risk parameters of the internal model to the business they are modeling and/or by explaining RWAs variance over a given period of time.
On the contrary**, UniCredit does not consider appropriate the BCBS proposal to regularly disclose the results of banks' standardised calculations** as a way to provide an alternative benchmark against which modeled outcomes could be compared. This proposal may in fact generate negative market consequences. The market would be likely to end up looking primarily at capital ratios, calculated according to the standardized formula, which are easier to understand and compare. A simpler approach would ultimately prevail to the detriment of risk accuracy, not to mention the additional costs.

Any IRB system requires supervisory validation and formal authorisation. Approval is granted only when national supervisors have the complete assurance that all requirements for using the IRB approach have been met. UniCredit believes supervision and reporting processes should be reinforced through a greater level of consistency in methodologies and transparency, a higher coordination within college of supervisors, and an enhanced homogeneity of regulation across countries. **A strong supervision and stricter approval of models** are key to ensure adequate measurement of the bank's risks and therefore that the capital allocated to assets is commensurate with the risks.
Another source of concern is related to the extensive **use of transitional floors to capital requirements by regulators.** The way and the amount of these floors vary across jurisdictions and it is a relevant source of RWAs variations. Hence, a convergence on the use of the floors is widely recommended, eliminating all the national discretions.
Finally, amongst the solutions provided by the BCBS, **UniCredit believes it would be important to substantially stress a stronger reduction of the external factors,** starting from the national discretions, as they significantly influence the environment in which banks operate. The differences between jurisdictions and supervisory practices should be limited as they reduce the comparability and effectiveness of capital ratios as main indicator to assess banks' solvency and resilience across countries.

Even if in its recent top-down analysis on banking book the BCBS stated that inconsistencies - due to what UniCredit refers to external factors - represent just a few (residual) part of RWAs divergences, UniCredit acknowledges that the international harmonisation of supervisory practices would positively impact the trust of the investor community. In this regard, **UniCredit calls for** actions aimed at promoting best practices and a level playing field in term of risk management across EU member states. In this regard, we trust the Single Rule Book and Supervisory Manual to be respectively drafted by the EBA and ECB in its capacity of **Single Supervisory Mechanism (SSM)** should help to reduce many of the existing inconsistencies.

UniCredit answers to specific questions

Question 1: Does the current framework, with its reliance on the risk-based capital at its core, appropriately balance the objectives set out in paragraph 29?

Paragraph 29 recalls that the capital adequacy framework should:
- produce a sound minimum standard of capital adequacy for internationally active banks, but also be capable of application to smaller institutions;
- deliver a well-understood measure of capital adequacy that is comparable across banks and over time;
- support a reasonable level playing field between banks take into account the effects of capital requirements on banks' risk-taking incentives, e.g. when faced with regulatory constraints on their capital (and therefore the size of their balance sheet), to seek higher-risk assets as a means of boosting expected returns; and
- promote improved risk measurement and management within banks.

UniCredit thinks that the current internal modelling approach that has been adopted by large international banks allows capital adequacy calculations to better reflect each bank's risk profile than non-weighted capital measures. Therefore it is more conducive to financial stability. Such advantages of internal models are also experienced by - and work as an incentive for - smaller or less sophisticated institutions, reducing incentives for regulatory arbitrage.

UniCredit acknowledges that recent studies performed by EBA, IMF, BCBS, and other banking authorities and associations, such as EBF, have revealed that RWAs variance is significant even in homogeneous models of banks, rising concerns on the efficacy of internal model calculation as well as on the clarity of a common minimum international capital adequacy. These differences can be explained by the fact that internal models developed by banks are complex and might generate difficulties in assessing their quality and robustness. **Each bank has its own assessment regarding risks**, **which results in differences between credit risk parameters and credit decisions**. These may lead some investors to focus their attention on simpler, more objective and easier to compare measures such as the leverage ratio and not to consider risk related measures.

On the other hand, there are a number of **external factors outside the control of banks, that can explain the differences.** More **convergence in accounting standards and in regulatory frameworks** would favor a higher RWAs comparability. Indeed there are material differences in reporting balance sheet assets depending from the accounting standard used. For example, European, North American and Asian banks report under different regulatory practices, avoiding a sound and consistent RWAs *cross-border* comparison. US banks adopt both Basel I and II while European banks report under Basel 2.5. In the US, where the attention is on the leverage ratio, banks appear to focus on the return on assets, increasing their risky activities. On the contrary, EU banks seem to be more focused on assets carrying low RWAs, in order to increase their capital ratios.

Question 2: Are there other objectives that should be considered in reviewing the international capital adequacy framework?

Comparison of RWAs among banks is often made by reference to total assets, but those **total assets depend on the accounting policies applied.**

For example, there are material differences in reporting balance sheet assets depending on the accounting standard used. US GAAP allows the netting of derivates that under IFRS is not permitted. In this sense, assets reported under US GAAP are significantly lower that they would be under IFRS, consequently increasing the average RWAs density[2] of US banks vs. the European ones[3].

Thus, UniCredit suggests to consider an additional objective in reviewing the current capital adequacy framework: **the development of a greater convergence between accounting standards and risk-based capital regulation** in order to guarantee and strengthen financial stability as well as comparability across countries and banks.

Question 3: To what extent does the current capital framework strike the right balance between simplicity, comparability and risk sensitivity, given the costs and benefits that greater risk sensitivity brings?

It is acknowledged that the current capital framework – through the IRB modelling approach – guarantees benefits in terms of management practices, efficient capital allocation and alignment of risk with business practices.

[2] RWAs density is the ratio between total RWAs and total assets. This ratio, referred to as "RWAs density", should be used with caution: firstly there is an inconsistency between the numerator and the denominator regarding the elements taken into account in the computation. The Risk Weighted Assets computation applies not only to credit risk but also to market and operational risks, and takes into account off balance exposures. No exact equivalent of any of these items is taken into account in the Total Assets measurement. Secondly, there are differences in reporting of assets on balance sheets, for example between US GAAP and IFRS used in Europe. US GAAP supports substantial netting of items reported gross under IFRS, notably derivatives and repo positions. Comparing the RWAs density ratio across banks and drawing conclusions from it, as analysts did repeatedly in the last months, appears therefore as an exercise full of pitfalls that requires a very thorough analysis. It is important to note that the overall capital requirement for IRB portfolios includes also the shortfall, therefore, in alternative to RWAs density, also the Global Charge Ratios, which include in the numerator the Expected Loss ((RWAs+EL)/TA)), is used.
[3] This is even more material for those banks with a very high incidence of investment banking activities.

The use of internal models, by definition, makes required capital more **risk sensitive** and, therefore, helps supporting financial stability**. UniCredit deems that internal approaches lead to a clear evaluation of each bank's risk profile**, allowing capital requirements' calculation to reflect bank real riskiness, thus permitting banks to be closely aligned with risks - the opposite of unweighted capital measures.

Moreover, internal models foster the development of sound internal processes and methodologies to identify, measure and address risks as **i) IRB systems are crucial to the analysis of credit risk** (i.e. selective lending policies); **ii) IRB parameters quantify credit quality beyond traditional measures** (e.g. non-performing loans ratios, cost of credit provisions). This makes it **easier and simpler** for risk managers to monitor credit quality trends, enhancing the capacity to anticipate credit quality deterioration, which would not be possible without these models; **iii) Internal models' capacity to quantify expected loss enables banks to quantify credit loss provisions in a more objective way**. The current accounting model, based on the "incurred loss" concept which has been deemed inadequate to protect against financial crisis, is now under review in order to adopt a forward looking approach based on expected loss.

In this sense, IRB models play a key role, not only to determine the required minimum capital, but also to quantify in a more robust way **credit impairment provisions** which, after gross income, constitute the second line of defense against credit losses. IRB calculation allows the estimation of the expected loss of transactions, customers and portfolios and, subsequently, its adequate allocation as credit cost in pricing models. It improves the risk-return relation, having the credit margin as the first line of defense against credit losses.

The current regulatory requirement of disclosing to the market a number of elements pertaining to risk management and capital adequacy through Pillar 3 reports has provided the market with extensive information on banks portfolio quality since 2008, **at a level of detail never seen before**, **thus helping comparability across banks**. However given the "unique" character of internal models, linked to institutions specificities in terms of portfolio selection, type of business, risk modeling, etc, **market analysts have a hard task**. In fact, comparing Pillar 3 reports across banks, may bring analysts to draw wrong conclusions, and thus questionthe IRB models' reliability. Banks should then provide information to enhance IRB models readability. **As the market is asking for more comparability, it is necessary to respond with enhanced disclosure** and to improve market comprehension of business models and risks.

For example, during the 2010 and the 2011 EBA stress tests, investors have been impacted by the difficulty to analyze and compare bank's losses and exposures.

In this context, UniCredit acknowledges that the forthcoming Asset Quality Reviews and Stress Test - to be conducted next year by the ECB, in close coordination with the EBA – might increase the visibility of the potential inconsistencies and underlying reasons.

Accordingly, UniCredit draws the attention to the need for the ECB to take into account and disclose the existing divergences due to external factors across EU banks. This can be an important exercise for competent authorities to identify areas where consistent legislation and accounting standards, harmonised rules and common supervisory practices able to restore market's trust on banks comparability are needed.

However, **Pillar 3 makes more sense if used to monitor a given institution over time rather than to compare it to peers at a given point in time.**

Supervision and reporting processes should be reinforced through a greater level of consistency in methodologies and transparency, a higher coordination within college of supervisors, and an enhanced harmonization of regulation across countries. In this regard, UniCredit strongly supports the forthcoming legislative reforms related to the **Banking Union in EU**, including the **Single Supervisory Mechanism (SSM)** led by the ECB and the increased role of EBA. Noteworthy, especially in terms of strengthening the harmonisation of supervisory practices, are the Single Rule Book and the Supervisory Handbook by EBA as well as the Supervisory Manual by the ECB.

Question 4: Which of the potential ideas outlined in section 5 offer the greatest potential benefits in terms of improving the balance between the simplicity, comparability and risk sensitivity of the capital adequacy framework?

UniCredit welcomes the studies undertaken by the BCBS on the consistency of RWAs both in banking and trading books across banks and jurisdictions.

As to the proposal to limit national discretion and improve supervisory consistency, UniCredit strongly agrees with BCBS on the idea that practices used by national supervisors for validating models and implementing Basel rules should be harmonised in order to avoid unjustifiable misalignment in risk assessment across regions. **International harmonisation of supervisory practices is vital to ensure a real level playing field across and within countries, and to define common and transparent standards to comply with**. In this regard, **UniCredit strongly supports the envisaged Single Supervisory Mechanism (SSM) and EBA in their efforts to reduce the inconsistencies due to the so-called external factors.** These factors are relating to differences between jurisdictions, often cited as 'level playing-field' issues, in legislation of the financial sector, financial accounting regimes and national and supervisory practices.

It is equally important that the **relevant regulation is not overly prescriptive**, recognizing the diversity of practices across the industry as long as they rely on sound principles. Too prescriptive guidelines would potentially penalise banks relying on sound methodologies, therefore creating systemic modeling risk by triggering herd behavior and introducing moral hazard as banks would have less accountability of model design and calibration.

With reference to Pillar 3, **UniCredit agrees with BCBS on the importance of initiatives such as the recent recommendation of the Enhanced Disclosure Task Force (EDTF)[4] which offered specific ideas for improving the drivers of RWAs.** The EDTF has set out a framework for the disclosure of a greater quantity and quality of information, which will improve market understanding of business models, risks and RWAs.

UniCredit deems that the further harmonisation of Pillar 3 reporting requirements along the lines recommended by the EDTF would provide a better way to understand the differences between IRB models, for example by linking the risk parameters of models to the business they are modelling and/or by explaining RWAs variance over a given period of time by reference to the main model drivers.

In this regard, **UniCredit deems that increased disclosure of information supporting RWAs calculations** will improve market confidence in RWAs and the models on which they are based. It represents the way forward, and definitely the better option for all parties than a return to a standardised capital calculation. It is however important to balance disclosure requirements with confidentiality concerns and cost benefit considerations.
In this last regard, UniCredit is concerned by **the BCBS proposal to require banks to disclose, in addition to modeled calculations, also the standardised ones**. This additional proposal may generate negative consequences as the market would likely end up looking primarily at capital ratios calculated according to the standardized formula, which is easier to understand and compare. In this regard, a simpler approach would prevail to the detriment of risk accuracy with unforeseen consequences on market behavior, not to mention the additional costs, including those related to the infrastructure investments needed for reporting on this basis. More specifically, with reference to the proposal to regularly disclose the results of applying internal models to standardized hypothetical portfolios, UniCredit deems this measure untimely given the still significant impact of different regulatory approaches embedded in the estimates; at the same time higher complexity may be introduced in the interpretation of the results due to factors such as the level of representation of the selected hypothetical portfolios which may be significantly different among banks.

As to the use of the leverage ratio, UniCredit recognises its role[5] provided it is used as a supplementary measure to the risk-based capital framework and to the extent its definition is harmonized and a level playing field is implemented across borders. This said the intended role of the leverage ratio in BIS 3 is to serve as a backstop to the risk based ratio, therefore it should be considered that any proposal aimed at making the leverage a binding ratio would undermine the benefits of the risk based approach.

[4] Financial Stability Board, Enhanced Disclosure Task Force, The risk disclosures of banks, report presented to the FSB, 29 October 2012, www.financialstabilityboard.org/publications/r_121029.pdf. On 21 August the Enhanced Disclosure Task Force (EDTF) Progress Report was published.

[5] The leverage ratio brings two important benefits within the capital adequacy regime: (i) it constrains the build-up of leverage in the banking sector, which the risk-based regime is not designed to achieve, (ii) it reinforces the risk-based requirements with a simple non-risk based "backstop" that provides a floor to the outcome of risk-based capital requirements, thus, it provides a protection against model risk and the reduction of capital requirements via the optimistic use of models.

Indeed, while we understand the underlying reasons of the BCBS proposal to use additional **metrics such as the "tangible leverage"** [6] **and/or the "leverage ratio together with the standardised approach"** [7] as they would simplify and make it easier for the market to analyse and compare RWAs across financial insititutions, UniCredit thinks that the right balance between simplicity, comparability and risk sensitivity envisaged by the BCBS would not be achieved in a correct way, with negative effects on banks' risk accuracy.
For example, since the leverage ratio reinforces the risk-based requirements with a simple non-risk based cap to banks' asset inflation, banks would be then incentivised to select assets only on the basis of the expected return they would provide, regardless of their implied risks. In this way the comparison across banks would be easier but it would not provide a comparative risk analysis, limiting the industry capability to estimate the bank's risk-reward profile

The same shortcomings would materialise with the standardised approach. Despite the standardised approach could contribute to improve RWAs reliability and simplicity, the main negative aspect to take into account would be a reduced granularity in risk assessment. Moreover this solution would disincentive banks to enhance their risk management accuracy which would finally translate in a diminished understanding of risks and as a consequence in higher vulnerability of banking sectors to external financial shocks. Another negative consequence would be a reduced capability for banks to allocate properly credit cost in pricing models, which would eventually translate in inefficient lending selection policies.

Against this background, **UniCredit would suggest to use additional metrics in combination with risk-based capital ratios, in order to achieve both simplicity and risk sensitivity in the capital framework.** The use of additional/new floors could represent a feasible way to ease the process of RWA comparability and simplicity of the current capital framework provided a common level playing field among banks is ensured. It would be worthwhile starting to eliminate or reduce the differences caused by the different floors or multipliers applied by national supervisors to market risk RWAs, since this type of risk is not location-dependent and national discretions can hardly be justified. For the other risks' RWA, national supervisors' discretion to impose a specific multiplier or floor should be limited within a smaller range defined by the EU level. In any event, the implementation of this national discretion should be regularly monitored by the European competent authorities.

In this context, **UniCredit believes that the use of floors should be limited and well designed in order not to eliminate the benefit of a risk-based approach. Moreover, there is need for a common definition of floors, able to eliminate all relevant misalignments across countries**.

Question 5: Are there other ideas and approaches that the Committee should consider?

The capital requirement regulation currently in force leaves room for several national discretions on various topics.
Among others, UniCredit would raise BCBS attention on two issues:

- Definition of default. **It is a crucial component of all IRB approaches and it is an area subject to large differences across countries**. The guiding principles for the definition of default are given in the regulations. However, these principles leave space for interpretation, and may deviate due to differences among regions and regulations, as well as internal policies, practices and business models of banks.

  These differences are related to the numbers of days for the default definition, the presence of cross-default rules, the relevance threshold, the rules for return in performing loans, the treatment of the default portfolio, the loan loss provision (LLP) practice. Therefore, **there is a clear need for competent authorities intervention in this area in order to create common supervisory practices and harmonised regulatory treatment of defaulted loans across countries.**

- RWAs benchmarking. **It is a helpful safeguard against model risk, since it brings real added value**

[6] Under such an approach, standards could be set using a single form of capital – tangible equity – and a single measure of risk – tangible assets. Tangible equity is equity as normally defined minus add-ons such as goodwill, minority interests and deferred taxes assets that are of limited value in a crisis. Tangible assets are all assets, minus intangibles.

[7] Under such an approach, the regulatory framework would use a leverage ratio and a standardised risk-based approach together, but abandon the use of the internal models approach.

to the model validation process. Financial institutions and regulators should agree on common standards to conduct benchmarking exercises in a way that removes any ambiguity that could alter the results. UniCredit would recommend the possible standards to be set out following the points below:

- benchmarking RWAs across banks should be regularly conducted;
- participating banks should take part in the specification of the benchmark portfolios to ensure they are consistent with market practices and standards, and representative of banks portfolios;
- due consideration should be given to the relative size of single portfolios as it is a key element for capturing the diversification effect at the global portfolio level;
- a sanity check on portfolio market values should be performed by the competent authorities a few days prior to the official reporting period;
- credit risk and market risk measures should be reported on a dual basis [8], one free from national supervisor specific requirements and another including them [9];
- results of the benchmarking exercises should be disclosed to participating banks on an anonymous basis and they should be extensively shared among competent supervisors;
- the benchmarking exercise should lead competent supervisors to undertake concrete actions to reduce the RWAs discrepancies across banks due to the so called external factors. Concerning the so called internal factors, supervisors should also try to identify cases where the outlier's results are due to inaccurate or too lenient methodologies and should ask outliers to take corrective action.

[8] Nevertheless, UniCredit acknowledges the difficult application on an ongoing basis for credit risk since additional requirements are often embedded into the models…

[9] For example, for market risk, the VaR indicator should be reported both on a stand-alone basis and a regulatory assigned multiplier.

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