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UniCredit reply to the second BCBS consultation on “Revisions to the Basel Securitisation Framework

UniCredit is a major international financial institution with strong roots in 17 European countries, active in approximately 50 markets, with more than 8,800 branches and over 147,000 employees. UniCredit is among the top market players in Italy, Austria, Poland, CEE and Germany.

Introduction – A few highlights on UniCredit experience

UniCredit utilizes securitisation for multiple purposes:

- Group funding and liquidity purposes;
- efficient funding of customer-driven transactions;
- direct investment in ABS securities; and
- hedging certain risk and optimizing capital consumption.

Whatever the purpose of the use of securitisation is, securitisation will provide clear benefits for the real economy. In fact, true sale securitizations represent an important diversification of the funding sources. In addition, European market led initiatives such as: the PCS label ("Prime Collateralised Securities"), the ECB loan by loan template (intended to ensure greater market transparency) as well as the as well as the revised Liquidity Coverage Ratio (“LCR”) which now incorporates some RMBS notes potentially among the high quality liquid assets (HQLA) could further contribute to the overall effectiveness of securitization market and its contribution to the funding needs of the real economy.
Finally, UniCredit operates through the synthetic securitizations framework to optimize capital allocation both on existing/originated loans and on loans to be granted. For existing loans, synthetic securitizations allow to optimize the capital absorption to be deployed for new loans. Synthetic securitizations on loans to be granted provide the further benefit to improve borrowing costs for new small and medium enterprise (SME) customers. Such synthetic securitization structures involving new loans have recently been used by Sovereign European Funds (EU/EIF CIP Program, Jeremie Program, Fondo Centrale di Garanzia – SME Portfolio Guarantees, ISMEA – Agriculture Portfolio Guarantees) and National Government Funds (e.g. as far as Italy is concerned the “Fondo Centrale di Garanzia” - the Public Offer for Patents by the Ministry Of Economic Development) as a supporting facility for SMEs with the ultimate scope of supporting new lending activity also under difficult market’s conditions.

Main highlights on the new “Revisions to the Basel Securitisation Framework”

UniCredit appreciated the effort by the Basel Committee on Banking Supervision (BCBS) to integrate some of the comments on the first consultation paper, in particular on the implementation of a floor in an intermediate value between RW of covered bonds and RW of senior unsecured tranches, and in relation to a new proposed hierarchy. However, in UniCredit opinion, the proposed securitisation revision framework continue to **significantly and unnecessarily increase the costs related to securitizations (both synthetic and true sale), hampering the economic viability and effectiveness** of these instruments, with potential detrimental consequences in terms of lending to the real economy. The BCBS should consider the fact that, **differently from the US market, most securitisations in the EU incurred <u>zero</u> losses;** this is the case for instance of RMBS and senior tranches of

securitizations involving well-established "real economy" asset classes [1]. In addition, EU legislation on credit ratings requirements and EU regulatory changes relating to continuing disclosure and retention ("skin in the game") have already addressed the most relevant fundamental risk concerns arising from the financial crisis.

The Basel revised framework would still severely limit the use of securitisation to finance real economy assets funded by banks (that represent ca. 70% of the securitizations market investors base), as a result of increased borrowing costs due to increased capital requirements. It will be still conducive to significant distortions in the market among debt instruments and the negative impact will be immediately factored in by the market. The combination of a reduced investor base coupled with potentially sizeable bank disposals would unquestionably negatively influence ABS spread levels.

The proposed framework is contrary to the efforts of the regulatory community to encourage retail and SME lending. The new proposed risk floor will cause a further downsizing of the securitization market, while on the contrary actions aimed at rivitalising and not hampering new securitazion transactions should be put in place, coherently with the indications from ECB President in January at Davos. Mr Draghi clearly stated that the turmoil affecting the securitisation market is one of the main cause behind the recent credit crunch.
The **absence of grandfathering provisions is also regrettable,** since this will exacerbate the negative impact with higher impairments on existing books and has also an immediate impact on existing and future financing costs.

General considerations on the hierarchy of approaches

Although the proposed approach on the hierarchy is appreciated by UniCredit as an element of discontinuity with respect to the current situation based on external ratings, the following points summarize the key areas of concerns from our point of view:

1) The RWA proposal by BCBS is still unjustifiably higher compared to the previous BCBS consultation released in December 2012

a. **Tranches thickness and maturity**: the Internal Rating Based Approach (IRBA) incorporates maturity and tranche thickness (for non-senior securitisation tranches) as additional risk-weight determinants. Both maturity and tranche thickness (like assets' type and portfolio granularity) are already factors considered by the rating agencies in their analyses of the credit enhancement to be assigned to each note; hence any add-on attributable to these factors would appear to be duplicative. Moreover transactions with maturity less than one year are more penalized in terms of the RW although the credit risks are insignificant.

b. **Senior tranches RW Floor**: according to the new proposal, the IRB capital requirement for the most senior tranches of securitizations would increase to 1.2% from the current 0.56%, representing a rise of over 114%. Moreover, in the case of senior tranches evaluated under the new external rating table with a 5 year maturity the increase would be even stronger, with a capital requirement increase of 2% from the current 0.56% level. Furthermore, the new proposal reduces the economic benefit arising from the securitization of high quality assets, thus causing an adverse selection effect since banks would be incentivized to securitize only low quality assets. **We remain anchored to the proposal highlighted in the first BCBS consultation of December 2012 which envisaged that, at least for certain high quality asset classes and for Prime Collateralized Securities (PCS), the risk floor should be aligned to the 10% risk weight required by the regulators for AAA rated covered bonds.** We do not see any reason that justifies for senior notes a risk weight which is 50% higher than the level envisaged for covered bond. In fact, the protection for an investor in covered bond and in senior notes is quite similar, hence a different treatment is not justified in our opinion. The covered bond investor has the guarantee of the issuer and a preferential recourse to specific collateral, however also the senior note investor has a valuable

[1] Source Fitch "Global Structured Finance Losses of October 2, 2013. In the Fitch analysis on securitization issues between 2000-2012 years, with volumes of issuance similar, the losses realized in the European RMBS are null in respect of US transactions with value equal to ca 5% and a value of losses estimated by Fitch in the same report of about 10%.

protection, i.e. the guarantee of the segregated asset pool, even further enhanced through the securitizing tranching structure. Hence in order to avoid unnecessary distortions, **UniCredit would propose, for asset classes with 5 year residual maturity a floor on the RWA that is fixed at the same level of the RWA requested on senior unsecured bonds.**

c. **RW of securitization structures:** although this framework reduces the risk weight applicable on the securitisation structure (tranches), it is still unjustifiably far higher than the current framework. In a framework based on the IRB, the risk weight of the notes will be continuously updated (each month or quarter) according to the underlying assets' risk parameters. This would not allow an undervaluation of the risk in the banking system. Accordingly, if the BCBS aims at increasing the risk weight of senior/non-senior tranches, it would need to balance the total risk weight of the securitization structure by reducing the risk weight of other tranches (e.g.: of mezzanine tranches). In fact, UniCredit's view is that securitization structures should not have a higher capital requirement when compared to the unsecuritized assets (underlying average risk weighted asset). In the IRBA formula we would expect a rebalancing factor in order to offload the notes over a certain attachment point (e.g. an attachment point equal to the expected losses of the underlying portfolio over the securitisation period). As a result this rebalancing factor should cap the risk weight of the securitization structure to the risk weight of the underlying assets. UniCredit deems that a regulatory threshold issue between rivitalisation and closure of the securitisation market is to **balance the risk weight provided by IRBA on the securitisation structure and the risk weight of the underlying assets.**

d. The proposed RW level would make useless the recent initiatives launched by European and National Funds (EU/EIF CIP, COSME Program, Jeremie Program, Fondo Centrale di Garanzia – SME Portfolio Guarantees, ISMEA – Agriculture Portfolio Guarantees) aimed at supporting SMEs lending. This kind of portfolio's guarantees are used to support SMEs and generates value for the whole credit chain (small and medium enterprises, banks). Banks, using the Securitisation framework, can hedge their books and release RWAs. These benefits are rebated with amore favorable pricing to the SMEs, thus giving them easier access to credit with a large leverage (around 20 times the guarantee) for the guarantor. The new proposed framework reduces almost to zero the RWAs release achievable through these type of securitisations. This would hamper the functioning of these SME financing initiatives, which are already in place and fully working.

2) even if senior tranches with lower external ratings associated to sovereign risks will benefit from lower risk weights , there is a distortion introduced by the existence of the external ratings' ceilings. Such ceiling distortion is more applicable to investors (which will tend to use external ratings) than banks originators (which will tend to use the internal ratings and therefore ignore the rating ceiling). The practical implication of such a ceiling distortion would be that lower RWAs, requested by BCBS on lower rating tranches, would push the investments in riskier tranches, which seems inconsistent with the overall BCBS intentions. **UniCredit suggests to review the methodology by taking properly into account the distortions stemming from the external rating ceilings.**

3) Mixed pool: UniCredit applauds the Committee's efforts to provide greater flexibility in applying the IRB approach to "mixed pools" but questions the mandatory RW of 1250% for exposures for which IRB inputs cannot be calculated. Specifically, in cases of mixed pool that utilize IRB and Standardized approaches, an indication by BCBS of **a threshold in order to utilize the approach dominant in the exposure calculation is preferred**. Moreover, the requirement to assign 1250% risk weight to exposure for which IRB inputs cannot be calculated is too restrictive and excessively burdensome, particularly considering the fact that a stand-alone unsecuritised SA-position would receive a maximum risk weight of 150%, normally of 100%. UniCredit proposes to maintain the current approach of the "prevailing" portfolio also for the future. In this case the application of the IRBA would be allowed, provided the IRB portfolio is higher than 50%. On the remaining portfolio, the average risk weight may be usable.

4) Cliff effect: UniCredit notes with favor the BCBS intention to smooth the cliff effect under the current IRBA

framework, but has great reserves on the proposed method in order to reach this goal. Indeed the BCBS has increased the requirement on the highest rated tranches and correspondently lowered the one on the lowest rated tranches, a solution that will boost riskier investments. Therefore the new calibration proposal for the IRBA is counterintuitive or at least does not help to understand the rationale behind the increase of the requirements for the highest rated tranches.

5) Maturity - As highlighted in UniCredit reply to the first BCBS consultation, the definition of maturity must incorporate the concept of Weighted Average Life (WAL) based on the effective cash flow, then including also prepayments already realized based on contractual cash flow. If this is correct, UniCredit deems that the definition of maturity included in this BCBS proposal, built on a WAL based on contractual cash flow, would result in a value that would be artificially higher, mainly due to those "better" assets (in terms of reimbursement). Moreover, the framework does not seems clear about the default treatment in the WAL calculation. In this regard, from the investor point of view, the residual WAL of the notes tranches takes into account the defaults that are already realized. Indeed, following a default, the excess spread is trapped into the structure, in order to reimburse the more senior tranche thus shortening the actual redemption of the security.
Finally the maturity calculation of revolving transactions does not seem appropriate since the criteria of the revolving would have to be evaluated when they actually occur, otherwise portfolios with lower WAL (e.g. consumer loan, leasing etc.) would be transformed into medium and long-term assets and therefore penalized in terms of RWA.

6) Reliance on external rating - Priority in revised hierarchy given the Internal Rating Based Approach (IRBA) does not solve in our opinion the issue of excessive reliance on external rating. In fact, in order to use this approach a bank must have, for IRBA banks investing in securitisation exposures (for which they are not the originator), access to a central data warehouse in order to calculate KIRB. While on-going disclosure regarding underlying portfolios is now required by Art. 122a CRD, an IT infrastructure to capture the necessary information from the data warehouse relating to underlying pool performance and to calculate Expected Loss (EL) and RWA would likely be very expensive in our view. This is particularly the case when considering that many underlying pools would not have: a) an approved IRB approach rating requiring mapping to existing customers, b) new rating with existing rating models or c) the development of new rating models. The development of internal models will increase the potential for arbitrage where banks or local regulatory consider differently macro-economic factors, country risks, etc. Such different model approaches will lead to varying RW among banks /jurisdictions even if there are similar or identical exposures.

7) Proposed Calibration of the External Ratings Based Approach (ERBA) – A stated goal of the revised consultative document was to ensure greater consistency in RW for similar exposures between ERBA and SA. Unfortunately, in some cases, this goal is not achieved. In particular, the impact of sovereign and counterparty ratings on external securitisation ratings is not considered in both the IRBA and the SA. This leads to inconsistencies in relative ratings and in the resulting RW of certain securitisation exposures such as RMBS transactions in peripheral countries.

In addition, the proposed calibration of the ERBA results in relatively greater increase in RW for higher-rated exposures. For example, a five-year AA-rated exposure under the revised ERBA attracts a RW of 50% compared with 8% under the existing RBA, hence more than a six-fold increase in RWA. In contrast, a BB-rated five-year exposure is reduced from 450% to 230% RW. From UniCredit's perspective, this dramatically disadvantages exactly those quality assets and types that represents the core of the investor-driven securitisation market, such as auto ABS and RMBS. While we support the goal of reducing "cliff effects," the proposed ERBA would accomplished this goal, however with potentially very damaging consequences.

8) Internal Assessment Approach (IAA) – UniCredit supports the retention of the IAA in the consultative document, but remains concerned about the implications for ABCP financing of a 15% RW floor. As evidenced by the inclusion of IAA in the revised document, BCBS clearly appreciates the fact that asset-backed commercial paper (ABCP) represents a critically important and efficient financing tool for a broad range of companies. ABCP allows companies to derive liquidity from its customer financing activities and to use it to further expand such activities. The currently proposed floor will result in more than a doubling of the RW for AAA-equivalent IAA

exposures. The additional capital costs of such exposure will result in a similar adjustment in the pricing of ABCP financing for corporates which will, correspondingly, be passed on to customers. Given the nature of the underlying securitized assets in the ABCP conduits, such as short-term receivables, and the relatively high subordination levels, **UniCredit contends that a lower RW floor should be considered for IAA exposures**.

Answers to specific questions

Question 1: The Committee seeks input as to whether the proposed treatment of derivatives other than credit derivatives achieves an appropriate balance between risk sensitivity and simplicity; and welcomes respondents' views on how to improve upon the proposed treatment.

Answer 1
UniCredit has no suggested improvements to the proposed treatment of derivatives.

Question 2: While the formulation of the Internal Ratings-Based Approach is much simpler than the MSFA, the Committee recognises that there may be opportunities to make further simplifications by, for example, eliminating one or more of the four variables proposed to calculate "p," while achieving a degree of risk sensitivity similar to that of the MSFA. The Committee is interested in respondents' views on ways to simplify the parameterisation of "p".

Answer 2 – UniCredit deems adequate the proposed simplification of the parameterization of "p."

Question 3: If respondents favoured a pro rata calculation of the maximum capital requirement, the Committee would welcome arguments that justify that a pro rata cap would result in appropriately conservative capital requirements.

Answer 3 – It is unquestionably logical that the risk characteristics of underlying assets remain unchanged following a securitisation of those assets. Correspondingly, a sharing of the risk of those assets through the vehicle of securitisation should not increase (or decrease) risk. Rather, the aggregate risk remains the same. This point of view should provide the basis for any allocation of risk within a securitisation.

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Please find below the list of the key contact-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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