

**ABI COMMENTS ON BASEL
COMMITTEE ON BANKING
SUPERVISION CONSULTATION
PAPER
“REVISIONS TO THE
STANDARDISED APPROACH FOR
CREDIT RISK”**

March 2015

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Annex 1

Annex 2

Key Points

1. In our view the Basel Committee should change things that can be improved but, at the same time, should not hesitate **to keep the elements that work** or for which no tested improved treatment can be found in practice.
2. Although the paper states that the objective is not to increase overall capital requirements, the values of the parameters and factors proposed clearly indicate a **significant increase in capital**. In some parts of the consultation paper, the proposed Risk Weights (RW) for specific assets are higher than RW applied for the same assets classified as in default. In general, the RW for “performing” assets should not be higher than that for “non-performing” assets.
3. If the Standardised Approach serves as a **floor** there will be a significant impact on internal ratings-based (IRB) approach portfolios. These should be maintained for the invaluable source of risk information they provide to banks, supervisors and policy makers at global and national level.
4. In considering the need to remove references to **external ratings**, it should be noted that **criticisms** of the performance of and over-reliance on external ratings during the crisis focused more on certain asset classes, notably **securitisations and sovereigns, and not really on the ratings for corporates and financial institutions**. Also, pre-crisis over-reliance on external ratings was mostly observed on the buy/investment side. The fact that the new Basel securitisation framework still uses external ratings, as does the new market risk framework being proposed under the Fundamental Review of the Trading Book (FRTB), offers further evidence that complete removal is both unnecessary and undesirable.
5. External ratings represent a sound source of information for the risk appraisal of bank and corporate exposures. They are subject to self - assessment by institutions. **As in the current regulation, the risk weight should only be set at a predetermined level when no external credit rating is available** or, as a last resort, should be based on other parameters that are better defined and tested than those criticised in the proposal.
6. It is questionable that use of the proposed risk drivers will lead to **greater risk sensitivity**. This is especially true for bank and corporate exposures, where external ratings (which factor in a lot of information) are replaced by an approach that only looks at two risk drivers. As for other exposure types, granularity seems to be equated with risk

sensitivity. **Granularity may add to risk sensitivity only if the risk drivers used actually capture risk; otherwise, it does not improve risk sensitivity at all.** Moreover, as alluded to in the consultation document, there is also concern that the use of uniform risk drivers, which may not necessarily be relevant or would have to be calibrated differently by jurisdiction or by industry, will only result in a **false sense of comparability, while also leading to unintended consequences** (e.g. inadvertently putting firms in certain jurisdictions or industries at a disadvantage). Furthermore, the presence of additional risk drivers - such as mortgage insurance - should also be taken into account in order to improve risk sensitivity and therefore determine 'real' (lower) risk weights (because of the additional security provided for a given exposure).

7. The proposed changes would be likely to result in more **complex implementation, and the challenges would be especially acute for smaller banks.** First of all, the proposed risk drivers do not have **harmonised definitions across jurisdictions**, so implementing them in a comparable way would be challenging. Further, the **required information may not be readily available** (or at least not as defined in the proposals) to the bank processes that generate the regulatory capital calculations. The proposals would therefore be likely to lead to considerable IT investment. Limited information would also lead to higher capital charges that could worsen the impact of the proposed revisions.
8. It would make sense to **put in place global standards with local calibration.** Only in that way can appropriate calibration be achieved under common standards.
9. Specific local calibration for the EU jurisdiction is represented by the SME Supporting factor as in EU Regulation 575/2013 - Art. 501. **It is of outstanding importance that this special measure be included (for EU or worldwide) in the new Standardised Approach. Otherwise Standardised banks will face an unbearable penalisation in the EU.**
10. **The timeframe and depth of the quantitative impact study** and the ensuing calibration should be adequate. They should also take into account **the other consultation processes still underway at both Basel Committee level** (i.e. floors) and at **single jurisdiction level** (like the consultations carried out by the EBA in the EU and, in particular, the definition of the past due threshold and "unlikely to pay").

Section 2: Proposed revisions to the standardised approach for credit risk

(2.1) Exposures to banks

Q1. What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

1. **Given the contents of point 4 below, the CET1 ratio is the principal indicator of capital adequacy. Since it is representative of the bank's highest quality equity, it is preferred over the Tier1 ratio.**
2. The leverage ratio is an important indicator. As indicated by the EBA, it was introduced in order to monitor all those risks that are underestimated when determining risk-weighted assets, as well as to limit the risk of default associated with excessive leverage.
3. Capital adequacy in relation to the risks accepted cannot be evaluated solely by reference to the CET1 ratio, since this might not reflect all the risks to which a bank is exposed including, in particular, those associated with derivative instruments. **Accordingly, it is considered desirable to take indicators such as the leverage ratio into consideration.**
4. Given that LR will not be fully implemented before 2018 and, above all, that **external ratings are still a reliable and comprehensive indicator of exposure to banks, we recommend keeping "External Ratings".**
5. When evaluating a bank, it may also be desirable to consider liquidity indicators, such as the **Liquidity Coverage Ratio.**
6. We agree that all banks in all jurisdictions should calculate the CET1 ratio in accordance the Basel3 rules in force from time to time. The need for a level playing field also extends to other indicators used for the same purpose.

Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

1. The NPA is a good indicator of the credit risk to which a bank is exposed. If this indicator becomes a risk driver for the coefficients of prudential supervision, the methods adopted for its calculation by all banks in all jurisdictions should be as homogeneous as possible.
2. When assessing the total impaired assets of a bank, it may also be useful to consider their composition since, for the same net NPA, a significant presence of non-performing loans reflects a greater level of risk than a significant present of past-due loans.

Q3. Do respondents have views on the proposed treatment for short-term interbank claims?

1. The proposal seems to be **excessively penalising** with respect to the current situation, in which a 20% weighting is envisaged (subject to exceptions).
2. With regard to the question of whether it would be appropriate to incorporate country risk as an additional risk driver, we agree that country risk should be considered (especially where transfer risk is present), but it is difficult to imagine how this would be done in the proposed approach. We note that **country risk**, along with other risk factors, is already taken into account in a bank's **external rating**, making such a rating a simpler and superior risk indicator than the proposed two risk-driver approach.
3. Given all the issues outlined above and the fact that bank ratings did not really suffer from the same weaknesses as the ratings for structured notes and sovereigns, **we ask again for the external ratings-based approach to be retained for bank exposures.**
4. Moreover, the general rule under Basel II on the use of foreign currency and domestic currency ratings should still apply, i.e. use international/foreign currency ratings for exposures in foreign currency and domestic/local currency ratings, if separate, for exposures in the domestic currency.
5. The Basel Committee states that *"Claims with an original maturity of three months or less which are expected to be rolled over do not qualify for this preferential treatment. Interbank claims with an original maturity*

*longer than three months would not qualify for the preferential treatment". For short-term interbank claims, the additional requirement that such claims "are not expected to be rolled over" **would disqualify from preferential treatment those interbank placements that are normally rolled over.** This would have implications not only on capital requirements, but also on liquidity provisions among banks. In addition, there is the issue of who should determine if claims are expected to be rolled over: if it is the bank, we see a clear conflict of interest.*

6. Exposures towards banks with an original duration of less than 3 months have an extremely low probability of default, which more correlated with the liquidity available to the bank than its capital adequacy or net NPA.

In addition, since the BCBS believes that short-term claims in general carry lower risk than long-term claims, it would be **inconsistent not to extend this logic to banks attracting a relatively high risk weight.**

Accordingly, at least for short-term exposures (3 months), we request **maintenance of a single coefficient of 20% as at present. This will better reflect the riskiness of these items and simplify the calculations by avoiding multiple coefficients.** For intermediaries with exposures to other banks (not belonging to the same group) whose durations do not exceed 3 months, the principal issue is the increase in the capital requirement. This is because the weighting factor, currently 20%, would increase to at least 30%, which contrasts with the spirit of the document not push for greater capital allocations, but rather to take a more risk sensitive approach.

Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

The principal concern is the **complexity of obtaining the required information**, which is actually not available in some cases. Obtaining this information will require organisation at Group (or even market) level, in order to supply updated and reliable data for these indicators on a continuous basis.

(2.2) Exposures to corporates

Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

1. **Audited accounts:** the requirement is not applicable in Italy given that only 20.000 firms are by law obliged to present an audited balance sheet (this figure became 80.000 if the presence of a board of statutory auditors is considered as well). On the other side in Italy there are around 1.000.000 limited companies which by law have to present a not audited balance sheet every year. **Those financial information are of sufficient quality to be generally used for issuing internal ratings by regulator approved IRB banks** and that they have proven to be quite significant in discriminating firms with respect to credit risk. Requiring an “appropriate verification and due diligence” would impose an unbearable burden to standard banks. Then, **the requirement of an audited account should be dropped in the final draft** or if it will be maintained the presence of not audited account should be treated with a **risk weight of 100 %** and not 300%.
2. **If in Italy the issue can be solved by the above mentioned not audited balance sheet (widely used) availability of reliable financial statements could be an issue in other geographical areas**, leading to a situation similar to the current lack of external ratings. The fact that lack of information leads to a higher RW than the current level means that we see a risk of banks being penalised by this phenomenon.
3. The **assigned risk weights for corporate exposures appear quite punitive**. We observe, for example, that the risk weight for highly-rated corporates (AA or higher) will triple (from 20% to 60%), while non-rated, smaller businesses will be weighted at least 100% and up to 130%. This will definitely increase capital requirements. Empirical evidence should be produced showing that such risk weighting is warranted based on the past credit history of this asset class.
4. **The first issue is that we really do not agree with the use of absolute revenue as a risk driver**. In fact:
 - a. Size is not necessarily reflective of risk
 - b. In general, SMEs portfolios show default rates higher but more stable meaning a lower unexpected loss level. This behavior is

mirrored by the preferential treatment extended to small- and medium-sized entities (SMEs) under the IRB approach (by way of the size adjustment to the IRB correlation metric

- c. Moreover, the proposed treatment also disregards the fact that most exposures to smaller corporates are highly collateralised relative to the exposures to large corporates. **As such, we believe it worthwhile to consider a separate treatment for SMEs, to better reflect the characteristics of SME exposures as explained in the key points.**
5. UL estimation, based on **revenues**, could be criticised given that, in the PD model, this driver is not the most predictive at multivariate level (factors that are usually more predictive for corporate costumers refer to Financial expenses and Financial Structures). Moreover the relationship between the increase in turnover and the Risk Weight (greater the turnover, lower the risk weight) seems to be counterintuitive given the concentration issue.
6. The proposed risk weight patterns is **not consistent with empirical evidence**: according to an empirical analysis based on an extensive sample of Italian firms (more than 400.000 corporations observed for a time period ranging from 2010 to 2014) for Italy the pattern would be the following:

		Revenues			
		<5	5-50	50-1.000	1.000+
Leverage	1-3	100%	65%	65%	55%
	3-5	110%	90%	90%	90%
	5+	130%	105%	100%	100%

Source: CRIF.

According to the analysis performed by CRIF¹, the relation between leverage and risk is empirically sound; on the other side the relation between size and risk has a very different shape for Italy. This is probably due to the fact that the average firm size has a significant impact on the dimension. In fact, for Italy firms between 5 and 50 mil. € have default rates closer to large corporates and for this reason they do not require higher risk weights.

¹ The analysis estimates the increase / decrease in risk weight according to the foundation approach as a function of size and leverage as implied by annual default rates observed from 2010 to 2014 using a definition of default consistent with art. 178 of CRR.

Given that the relation between default rates and size is basically country specific it should be removed from a global rule.

7. **Bearing in mind the previous six point, it must be said that, as a general rule, differentiating risk-driver levels by macro-economic sector/type of business** (industrial production vs multi-year production, vs retailers) could be an option for greater precision in assessing risk without an unduly complex approach (in this case, business classification should be defined at Committee level, using for example the **Global Industry Classification Standard (GICS)** - an industry taxonomy developed by MSCI and Standard & Poor's).
8. **Summarising, we think that “revenues” and “leverage” are not very effective instruments for risk measurement.** With specific reference to the latter, if implemented, it should at least be adapted to reflect industry type and type of lending. For example, a leverage ratio of 2 could be low risk in one industry sector, but very high risk in another. In other words, the appropriate leverage measures should be industry specific.
9. Moreover, **there are sectors where “revenues” and “leverage” are not meaningful at all.** This is the case of the so-called “Confidi”, i.e. the mutual credit guarantee consortia active in Italy, France, Spain and other European countries. If they are treated as corporates – as seems to be the case, given that it is difficult to argue that supervised Confidi are subject to a level of supervision equivalent to that applied to banks (including capital and liquidity requirements) – they would surely be penalised by the proposals and would lose their ability to enhance SMEs access to bank credit. Of course this is not the only industry that would suffer from the use of such indicators.
10. The “revenue” driver, for example, could also be difficult to apply to **investment funds, which are independent entities, fully separated from the Investment Services Companies** (in Italy SGR, Società di Gestione del Risparmio) that manage them.

An investment fund could be classified as a “securities firm” (par. 2.1.i.-definition), but the approach applied to bank exposures cannot be adopted because it is not “subject to prudential standards and the level of supervision equivalent to those applied to banks” and “Claims on all other securities firms and financial institutions are to be treated as corporate exposures”.

Further, considering the risk drivers for corporate exposures, the definition of “revenue” in Annex 1 – par. 23 “all income the company received from business activities, as determined by the accounting

standards of the relevant jurisdiction", is difficult to apply to investment funds because their aim is to collect funds and administer them, with the result of this activity reflected mainly in the net asset value (NAV) of the fund.

So we suggest specifying the concept of "revenue" for investment funds or, alternatively, introducing another risk driver for these entities, that could be based on their net asset value.

11. We also believe that factoring deserves a specific approach due to its peculiarities.

In Italy, as in other jurisdictions, the estimates of the LGD in factoring are consistently lower than 15 %, while the SA assumes a flat LGD of 45 %.

For this reason, we suggest:

- a) **in the view of the alignment with the IRB approach, that it should be possible in the Standardised Approach (SA) to weight the exposure with the risk of the assigned debtor instead of the RW of the client, even in recourse operations.**

This is already possible worldwide in the IRB approach and - only for financial intermediaries but not for banks - in the Italian regulation. Alignment seems technically justified and would anyway preserve the incentive to move from SA to IRB.

- b) **providing a lower, specific RW for factoring exposures**, by way of a cap on the RW (i.e. all exposures to factoring can be weighted up to 75%, notwithstanding the RW indicated by the above-mentioned approach) or a cutoff of the RW emerging from the table (i.e. all RW for exposures to factoring are reduced by, for example, 25% or tbd).

10. Incorporation of off-balance sheet exposures will surely increase the risk sensitivity, but at the expense of greater complexity.

11. **Considering the significant problems posed by the new proposal we ask that the standardised corporate methodology be left unchanged and only slightly recalibrated, even though - considering the whole picture - we believe that capital requirements will be increased anyway in the near future due to other changes in the regulatory framework.**

Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

In the IRB approach, SMEs get a benefit on a single counterparty basis compared with Large Corporates, to take into account the diversification effect. The same approach would be expected here. The argument of the Committee (point 1 page 11 of the consultation paper) reflects the aggregated credit quality of the portfolio observed, not the inherent expected riskiness of SMEs vs Large Corporates

Specific local calibration for the EU jurisdiction is represented by the SME Supporting factor as in EU Regulation 575/2013 - Art. 501. **It is of outstanding importance that this special measure be included (for EU or worldwide) in the new Standardised Approach. Otherwise Standardised banks will face an unbearable penalisation in the EU.**

With specific reference to start-ups, we agree with the decision to allocate an average coefficient regardless of the risk drivers used for corporate businesses. **Nevertheless, the 110% risk weight seems too high and, moreover, it is unlikely that a start-up entity could reach a positive leverage ratio (or profitability) in just one year of activity.**

Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

1. We think that the proposed 300% RW for corporate exposures towards counterparties with **negative equity** would be unduly penalising for the Italian market, where SMEs are usually highly collateralised but with high leverage ratios.
2. **Cliff effect** - In general, the fact that SME counterparties can switch from retail (75%) to corporate (300%) due to variations in the exposure (more or less than 1 mln/Euros) can lead to undesired variations in RWA values and consequently in capital ratios.

Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

We agree with the fact that specialised lending requires an assessment that captures the real level of risk, nevertheless the proposed approach appears to be excessively penalising: **we cannot agree with the statement in**

the consultative document that specialised lending generally exhibits higher risk and losses than other types of corporate lending. We think that this assumption is untrue, at least for significant parts of the specialised lending asset class, such as Income Producing Real Estate (IPRE).

Specialised lending in fact requires a prospective assessment of both the project and the cash flows. The risk drivers identified do not appear suitable for assessing this type of lending, since revenues are often very low or almost zero in the early years and leverage is rather high.

We propose calibrating the final risk weight against factual experience and records of these activities. For that purpose, we would note that typical corporate lending is unsecured, whereas specialised lending is secured against valuable assets and cash flows.

Specific focus should be placed on the definition of development real estate assets, now that the new definition of real estate exposure is “fully completed”. Development real estate assets would be classified in the “SL portfolio”, thus significantly penalising this market which is really important for the GDP of most European Countries.

(2.3) Subordinated debt, equity and other capital instruments

(2.4) Retail portfolio

Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

1 Granularity criterion

The Basel Committee rightly considers the **diversification criterion** to be one of the primary justifications for the current preferential treatment. However, enforcing this criterion as a binding quantitative criterion - set at 0.2% of the overall regulatory retail portfolio – is not the right way to pursue the objectives of the proposed revisions to the SA.

The main drawback of following a ‘one-size-fits-all’ approach in this area and setting a very low threshold is that it can be reached extremely easily by institutions with small portfolios. Therefore, the small business-retail customers of smaller banks would be strongly discriminated

against and competition within the banking sector is likely to be distorted by regulation.

This can have a significant unintended consequence: the specific business model of small banks – informally-intensive and traditional lending activity (so called relationship lending) – might be adversely affected by the regulation for two main reasons:

- the too-small-to-succeed problem can be exacerbated by regulatory-induced incentives to grow in size (while we admit that, in some cases, mergers are likely to be the best way to increase efficiency and strengthen the resilience of very small banks);
- multiple banking relationships might result. The commitment of the bank towards SME-borrowers would be weakened and, in turn, pursuit of the typical benefits of relationship lending would be jeopardised. Therefore, multiple banking relationships might result in a degeneration of the basic management criteria of diversification.

Overall eliminating national discretion for the granularity criterion is not useful and does not strike the right balance among the objectives of (i) level playing field, (ii) financial stability and (iii) bio-diversity of financial and non-financial sectors.

Therefore we strongly advocate maintaining the granularity criterion as a qualitative requirement and national discretion to detail it.

Alternatively, we propose raising the threshold to at least 1%.

2 Loan size criterion

As for the threshold value of individual exposures, we believe that it should be raised to 1.5 million (this level was last determined at least 12 years ago) and adjusted for inflation on a regular basis.

3 Cliff effect resulting from SMEs migrating from the regulatory retail portfolio to the corporate portfolio

In general terms, where a simplified approach has been developed for smaller and less complex institutions, the 'cliff effects' should be avoided in order to prevent those less sophisticated solutions becoming a disproportionate burden for them. This might arise when a SME exposure migrates from the regulatory retail portfolio to the corporate portfolio.

In order to prevent a significant ‘cliff effect’, we believe that the current treatment of non-retail small business exposures should be retained. Alternatively, a 100 % risk weight should continue to be applied in the following cases:

- **sole proprietorship or self-employed or micro-small business entities that do not meet the criteria to be considered as retail exposures;**
- **SMEs that do not meet the loan size criterion.**

Exposures to small businesses where personal guarantees are given should qualify as part of the regulatory retail portfolio. Moreover, the size factor for small-medium enterprises (SMEs) should be set at an appropriate level, so as not to disadvantage this important part of the economy.

4 Specific products that have different risk characteristics and to which a risk weight of less than 75 % can be applied.

The Consultative Paper asks respondents to provide evidence about specific products that have different risk characteristics, compared with other retail exposures.

On this aspect, we propose a specific supervisory treatment for Salary Secured Loans and Pension Secured Loans (Cessione del quinto dello stipendio/pensione).

In Italy, these loans are governed by Presidential Decree 180/50 (and subsequent amendments and additions), by the related enabling Presidential Decree 895/50, and by various instructions from the Ministry of the Economy and Finance and the Bank of Italy on the proper implementation of the regulations.

This technical form of consumer credit is supported by a series of guarantees that reduce the credit risk in comparison with other forms of retail loan.

These guarantees include:

- (i) direct assignment of one-fifth of the pension or salary to cover payment of the loan instalments;
- (ii) mandatory insurance policies (“life cover” for loans involving the assignment of one-fifth of pension and “life and loss cover” for transactions involving the assignment of one-fifth of salary);
- (iii) transfer of the effects of the assignment of salary to the pension when the borrower retires;

- (iv) restrictions on access to the retirement bonus (trattamento di fine rapporto – TFR) and/or similar indemnities, with immediate recourse available to the creditor;
- (v) restrictions on possible attachments and seizures of the salary/pension that guarantee the privileges of the lender in comparison with other creditors.

Salary Secured Loans and Pension Secured Loans clearly have numerous characteristics that mitigate risk: accordingly, favourable prudential treatment should be applied with respect to alternative forms of consumer credit.

The evidence of a low level of credit risk is supported by the outcome of a **sample survey**² carried out by ABI that, with reference to pensioners and public employees, showed that:

- the probability of default (PD) within 12 months is 3.0%
- there is 32.6% return to performing status within one year
- the effective loss rate (weighted-average LGD rate) is 5.8%³
- the expected loss (EL) is 0.16%.

Accordingly, the theoretical risk weighting (RW) factor, calculated on the retail curve, is 8.4% (compared with the regulatory parameter using the current standard method of 75%).

In view of this evidence, it is requested that Salary Secured Loans and Pension Secured Loans be recognised as less risky than retail portfolio loans and deserve a much lower RW than the current RW for the retail portfolio (75 %).

A specific technical paper, with the characteristics and results of a credit risk assessment of this kind of consumer loan **is attached** (Annex 1) to the current position paper.

5 Retail Leasing exposures

Most of the equipment and automotive leasing exposures have the characteristics to be included into the retail exposures. Leasing companies can be specialised in specific sectors and asset industries and, in those cases, the proposed new granularity requirement proposed (0.2%) might be not fulfilled.

Nevertheless, retail leasing exposures deserve a 75% risk weighting because they have to be included into the category of "loans secured by

durable goods" [ref. Par. 2.4, ii) Treatment, point (i)]. In leasing contract the guarantee represented by the leased asset is even more strong as the lessor maintains the "ownership" of the asset for the whole duration of the contract.

Asset ownership represents a major advantage for lessors compared to other financial products. This is demonstrated by the results of a recent research conducted by Deloitte on behalf of the European Leasing Federation (Leaseurope). In the Deloitte's Report: *"The Risk Profile of Leasing in Europe: The role of the leased asset"*, it has been showed that default and loss rates for leases are significantly lower than for traditional lending. According to this study, which was based on a portfolio of 3.3 million lease contracts in 15 European countries, one-year defaults on leasing Retail SME exposures were 2.7% compared to 4.5% for all Retail SME lending in 2010. Similarly, Loss Given Defaults for leasing were 19.6% compared to 33% for all Retail SME lending.

The automotive leasing sector could also deserve a better treatment. Italian data about automotive leasing show lower percentage of defaulted contracts in the portfolio and higher recovery rates.

* * * * *

Furthermore, the "established relationship" might play an important role, especially if it is a relationship lending type (e.g. influencing the behaviour of counterparts in order to prevent and manage their crises). Therefore, further and deeper analyses should be carried out to ascertain if it can be considered as a risk driver (perhaps in combination with others) to better differentiate the risk of retail exposures and hence apply a risk weight of less than 75% to the exposures characterised by it.

Specific local calibration for the EU jurisdiction is represented by the SME Supporting factor as in EU Regulation 575/2013 - Art. 501. **It is of outstanding importance that this special measure be included (for EU or worldwide) in the new Standardised Approach. Otherwise Standardised banks will face an unbearable penalisation in the EU.**

(2.5) Claims secured by real estate

Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

Q13. Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

Q14. Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?

Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

1. Exposures secured by residential real estate

According to the Basel Committee Consultation Paper, residential real estate exposures would no longer receive a 35% risk weight. As a matter of fact, risk weights would be determined according to a look-up table where risk weights range from 25% to 100% on the basis of the two risk drivers: loan-to-value and debt-service coverage ratios (DSC). The relevant table reads as follows:

	LTV <40%	40% ≤ LTV < 60%	60% ≤ LTV < 80%	80% ≤ LTV < 90%	90% ≤ LTV < 100%	LTV ≥ 100%
Loans to individuals (DSC ≤ 35%)	25%	30%	40%	50%	60%	80%
Other loans	30%	40%	50%	70%	80%	100%

The risk weight applicable to the full exposure amount will be assigned, using the above table, based on the exposure's loan-to-value (LTV) ratio and, in the case of exposures to individuals, also taking into account the debt service coverage (DSC) ratio. Banks should not tranche their exposures across different LTV buckets; the applicable risk weight will apply to the full exposure amount.

A bank that does not have the necessary LTV information for a given residential real estate exposure must apply a 100% risk weight to such an exposure.

Comments

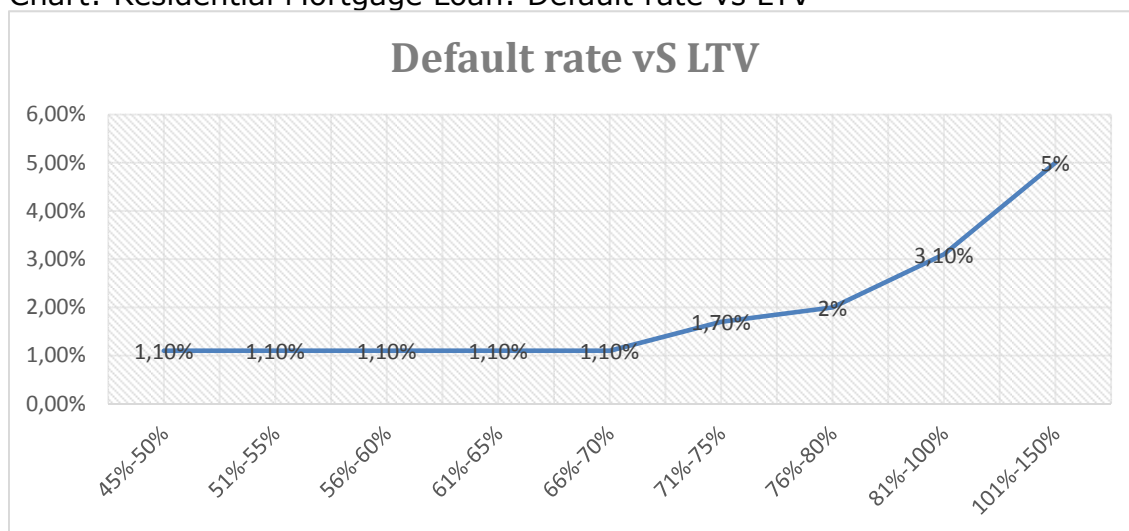
The Basel Committee proposal strongly penalises the development of European mortgage and real estate markets.

It will have also a significant negative impact on the ability of consumers to purchase residential real estate. Maintaining a $DSC \leq 35\%$, in order to apply the current risk weight, banks will be forced to grant mortgage loans with a LTV of less than about 50%. This means that consumers will have to finance at least 50% of the house market value with own funds.

The adverse consequences of this proposal could be:

- (i) inability of "low/middle income" consumers to access the homeownership market, with a further negative impact on the European real estate market; and/or
- (ii) a disincentive for lenders to grant (particularly high LTV) mortgage loans, with a general increase in residential mortgage interest rates affecting borrowers and indirectly also affecting their creditworthiness, in terms of the sustainability of instalment payments.

Furthermore, these proposals seem unsupported by specific data on the risk sensitivity of residential mortgage exposures based on the LTV. In fact, according to data collected by CRIF, the leading provider of banking credit information in Italy, the level of credit risk increases significantly after LTV exceeds 80%.

Chart: Residential Mortgage Loan: Default rate vs LTV⁴

Source: CRIF

Furthermore, if residential real estate exposures also benefit from additional collateral/guarantees, recognised under credit risk SA, this should be reflected in a lower risk weight (e.g. risk weight of the guarantor could be used instead of the risk weight of the borrower). This is relevant because often banks only grant higher LTV loans where such collateral exists (e.g. mortgage insurance, unemployment insurance, parent guarantees, sovereign guarantees, financial collateral). Mortgage insurance for instance reduces the LGD (as recognised in Bank of Italy Circular no. 284) and should consequently be used as a deduction from the LTV in the Standard Formula (i.e. lenders should be allowed to use 'real' LTV in determining risk weights, to account for recoveries from mortgage insurance, in addition to the underlying property collateral).

Supporting data also shows that mortgage insurance not only reduces/mitigates credit losses in the event of a default, but also reduces the risk of default across the LTV spectrum. **Because of this, mortgage insurance should be explicitly recognised as a credit risk mitigant and considered to be an appropriate/additional risk driver to improve risk sensitivity.**

Another point to focus on is the monitoring of DSC during the mortgage loan life. It could be difficult in some European legislations to collect this information because of privacy issues. **The DSC level should be assessed only at the time of creditworthy analysis.**

Again with reference to DSC, there is no common definition and the formulation of one that works seamlessly across countries seems unimaginable.

With reference to the destination of use of the considered real estate, mortgage loans to buyers of “first homes” (a home where people usually live and not just for a specific period of the year) have a lower expected loss than other kind of exposures: as a matter of fact, these householders are motivated to pay instalments to avoid losing their “own” (and often “only”) home, without considering the value of the property compared with the mortgage loan.

Proposals

DSC and LTV are important risk drivers for defining RW for residential mortgage exposures. Nevertheless, they are not the only ones, and could create some distortion in the residential real estate market.

Provided the DSC is <35/40 %, assessed at the moment of granting loans, we propose to increase the RW in case LTV > 80 %.

As anticipated before, we also propose explicitly recognising mortgage insurance as a credit risk mitigant and lowering the RW where mortgage insurance is in place, due to the additional security it provides for a given exposure.

In paragraph 40, the value of the loan is that “measured at origination”, but the proposed regulation then states “unless an extraordinary, idiosyncratic event occurs resulting in a permanent reduction of the property value. Modifications made to the property that unequivocally increase its value could also be considered in the LTV.” It implies that the bank should set up a system to monitor the real estate collateral, in order to detect these events. It could be beneficial to define more specifically what types of event are considered “extraordinary and idiosyncratic” (e.g. are fire, flood and other risks normally covered by specific insurance policies to be considered extraordinary and idiosyncratic?)

2. Exposure secured by commercial real estate.

With reference to exposures secured by commercial real estate, two options are currently under consideration: (a) treating the exposures as unsecured, with national discretion for a preferential risk weight under certain conditions (50%); or (b) determining the risk weight based on the loan-to-value ratios (from 75% to 120%).

Comments

First of all, it is not clear what the consultation paper means by “commercial real estate” (for instance, does this portfolio include hotels, industrial platforms, firms, offices, shops etc.?). **In this regard, we propose defining this portfolio as “non-residential real estate exposure” as EBA has already established (see EBA’s Single Rulebook Q&A 2014 1214).**

About the RW, both options proposed penalise the current RW, which is 50% for LTV < 60%. The first proposal allows the current RW to be maintained only if stricter requirements are fulfilled, and subject to national discretion. The second increases the current RW by 50%.

Both proposals reduce the importance of this collateral, which is used to cover SME exposures in particular. These proposals and the new “definition of default” will help to create credit crunch phenomena. Moreover, there is no data to justify this kind of penalisation.

We propose maintaining the current treatment and perhaps increasing the RW for exposures with LTV > 60% (the current threshold).

3. Commercial Real Estate Leasing

Real estate leasing differs from mortgages because the lessor maintains the “ownership” of the asset for the whole duration of the contract. The full ownership of the leased real estate allows the leasing company to finance the entire value/cost of the asset and grants a quicker recovery/repossession of the asset in case of default of the contract.

Therefore, the new approaches for real estate exposure proposed in the Consultative Paper based on the LTV ratio do not fit to real estate leasing market (a 13.5 billion sector in terms of yearly new business), which represents an important source of finance for business real estate investment (especially for SMEs) in some important European countries (e.g. Italy, France, Austria, Spain).

In our opinion, the LTV ratio (and the DSC for residential real estate) should not be the only main risk driver for real estate exposures weighting. The ability of the lessor to correctly evaluate the real estate asset financed should be part of the weighting mechanism. In particular, in addition to require higher risk weights for higher LTV ratio, it should be introduced a mechanism that, notwithstanding the initial LTV ratio level, would reward the lessor when the asset does not depreciate during the contract life; allowing him to apply a 50% weighting when the LTV ratio becomes lower than 60% (or 50% if referred to the market value, as specified in note 60).

For commercial real estate leasing, we propose to consider in addition to option A and option B, the possibility to adopt a third option: option B2,

that would work as follows. At the beginning of the contract, when real estate leasing LTV is $\geq 75\%$, the exposure is 120% weighted, when LTV ratio decreases down to the following range of values: $60\% \leq \text{LTV} \leq 75\%$, the leasing real estate exposure will be weighted at 100%; than when $\text{LTV} < 60\%$ (or 50% if referred to the market value, as specified in note 60) option A with note 59 could be applied with a 50% risk weighting of the real estate exposure.

In the Annex 2, we enclose the risk weighs resulting from the adoption of each of the 3 options (A with the national discretion, B, and B2) applied to a 12 years commercial real estate leasing contract:

- if the real estate value depreciates during the contract life (H1) the sum of the total weighting under option B2 is only slightly lower if it is calculated adopting option B;
- on the contrary, if the real estate asset maintains its value during the whole duration of the contract (H2), the sum of the total weighting under option B2 remains considerably higher than the current Basel 2 treatment (with the 50% rule under national discretion), but would be lower than that calculated under the proposed option B, with a reward to the leasing company that correctly evaluated the real estate at the beginning of the contract.

In remaining at your disposal for further simulations, we ask you to introduce the above mentioned third option.

(2.6) Risk weight add-on for exposures with currency mismatch

Q16. Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

(2.7) Off-balance sheet exposures

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?

Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

We do not agree with the treatment proposed for Off-Balance sheet exposures: in a "risk sensitivity" approach, it should be more effective to

define the level of risk with regard to the duration of the commitment (more/less than 1 year). Moreover, for committed lines with 0% CCF, we believe that the internal procedure allows lines to be cancelled unconditionally if the credit worthiness of the debtor deteriorates.

(2.8) Past-due loans

Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?

The short paragraph regarding past due loans is inappropriate because it mixes RW topics with provisioning matters, and also because the proposed approach would create a **sort of two-layer RW system** for defaulted positions, even if the prudential definition of default is unique (for the EU, art. 178 of CRR).

We ask the Committee to allocate the issues discussed in the paragraph to the relevant part of regulation (rules on "other risks" or provisioning) and to consider the importance of consistency between SA and IRB regarding the treatment of defaulted assets.

(2.9) Exposures to multilateral development banks

Q20. Do respondents agree with the proposed treatment for MDBs?

Considering the limited number of MDBs, instead of defining a mix of quantitative and qualitative criteria it would be more effective for the Committee to assign a specific risk weight to each of them, by applying in a centralised and uniform way the criteria defined.

(2.10) Other assets

Q21. What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible).

Currently, the prudential regulations envisage exceptions to the 100% weighting, e.g. for in-transit items, which we trust will be maintained.

Section 3: Proposed revisions to the credit risk mitigation framework for exposures risk-weighted under the standardised approach

(3.1) Approaches to be excluded

(3.2) Eligible financial collateral

Q22. What are respondents' views on the above alternative ways to define eligible financial collateral?

The goal of the alternative way proposed to define eligible collateral is understandable, but since it is based on a somewhat qualitative assessment it could lead to different risk assessments among banks for the same collateral, and/or to conflicts of interest for banks when assessing eligibility. An approach similar to that proposed for the assignment of risk weight to corporates would be appropriate (in this sense, Table 5 is a good example).

Q23. What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?

(3.3) Eligible credit protection providers

Q24. What are respondents' views on the proposed corporate guarantor eligibility criteria?

Under the current Basel Accord, only life insurance policies are recognised as eligible collaterals, subject to the fulfilment of specific requirements.

We propose including all types of policy issued by insurance companies, including non-rated insurance companies. The important factor is that the insurance company is authorised and supervised by public supervisory authorities and governed by European laws (Solvency).

(3.4) Treatment of credit derivatives

(3.5) Treatment of repo and OTC derivative transactions



**Proposal for a specific supervisory treatment of Salary Secured Loans
and Pension Secured Loans (Cessione del Quinto)**

January 2015

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Introduction

The prudential treatment of Salary Secure Loans and Pension Secured Loans (Cessione del Quinto) (Presidential Decree 180/50) and the consequent request for a recognition of a favourable risk weighting for supervisory purposes is an important matter for a large part of the banking industry. Two separate Position Papers (ABI - 6 March 2012 and 12 April 2012) have already been sent to the Supervisory Authorities, analysing the regulatory aspects of these loans.

As further support for this request and in response to a need for quantification of the phenomena expressed by the Supervisory Authorities, this document presents:

- a summary of the analyses presented in the previous two Position Papers;
- the results of a sample survey carried out together with Assofin - Italian Association of Consumer Credit financial intermediaries , intended to verify the riskiness of the market for Salary Secured Loans (especially by public employees) and Pension Secured Loans.
- the reasons underlying the requests made by the banking industry for a favourable risk weighting for this type of loan, having regard for the new supervisory regulations¹.

In particular, this document was prepared in collaboration with twelve sector operators², whose pro-active contributions are much appreciated. ABI also wishes to thank Assofin for the significant level of collaboration provided.

¹ See Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, which amended Regulation (EU) 648/2012 (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:IT:PDF>) and Bank of Italy Circular 285 of 17 December 2013 (http://www.bancaditalia.it/vigilanza/normativa/norm_bi/circ-reg/Circ_285_pub.pdf).

² The following intermediaries responded to the survey: BNL Finance, Futuro (Compass), Deutsche Bank, Fides, Fidelity, BF5 (Findomestic), IBL Istituto Bancario del Lavoro, Intesa Sanpaolo Personal Finance, Pitagora, Prestitalia, Santander Consumer Bank, Unicredit.

Executive summary

Salary Secured Loans (Crediti contro Cessione del Quinto dello Stipendio; hereafter **CQS**) and **Pension Secured Loans** (Crediti contro Cessione del Quinto della Pensione; hereafter **CQP**) are ruled by Presidential Decree 180/50 (and subsequent amendments and additions), by the related enabling regulatory Presidential Decree 895/50, and by various instructions from the Ministry of the Economy and Finance and Bank of Italy on the proper implementation of the regulations.

This **technical form of consumer credit is supported by a series of guarantees** that reduce the credit risk in comparison with other forms of unsecured consumer loans.

As guarantees the loans present the following characteristics: (i) backed by employees' monthly salary/retired pension and repayments may not represent more than 20% of the net monthly salary or pension; (ii) benefit from insurance covering the risks of unemployment (for non-retired obligors) and death of the employee, (iii) transfer of the terms and conditions of the assignment of salary to the pension when the borrower retires; (iv) restrictions on availability of employee severance pay (trattamento di fine rapporto – TFR) and/or similar indemnities, with immediate recourse available to the creditor; (v) restrictions on possible attachments and seizures of the salary/pension that guarantee the privileges of the lender in comparison with other creditors.

CQS or CQP clearly have several characteristics that mitigate credit risk: as a consequence, a more **favourable prudential treatment** is requested with respect to alternative forms of consumer credit.

The low level of credit risk is supported by the outcome of a sample survey³ carried out by ABI that, with reference to pensioners and public employees, showed that:

- probability of default (PD) equal to 3.0% (within 12 months)
- cure rate ratio equal to 32.6% (within one year)
- effective loss rate (weighted-average LGD rate) equal to 5.8%⁴
- expected loss (EL) equal to 0.16%.

Accordingly, the theoretical risk weighting (RW) factor, calculated on the retail curve, is 8.4% (compared with the regulatory parameter using the standard method of 75%).

In view of this evidence, it is requested that loans repaid by the **assignment of one-fifth of salary or pension** be recognised as loans **less riskier** than other retail portfolio loans and deserve a RW lower than the RW (75%) currently applied to retail portfolio.

³ Eleven of the twelve intermediaries referred to in note 2 participated in the survey described below, providing over 80% coverage of 2013 loans guaranteed by the assignment of one-fifth of salary or pension.

⁴ The weighted-average LGD rate was provided by a sub-sample of 7 respondents.

1 Background information

1.1 *Salary Secured Loans and Pension Secured Loans*

CQS and CQP are governed by Presidential Decree 180/50 and subsequent amendments and additions, by the related enabling legislation, Presidential Decree 895/50, and by various instructions from the Ministry of the Economy and Finance and Bank of Italy on the proper implementation of the regulations.

This type of loan is classified as consumer credit given the nature of the borrowers, being public or private-sector employees or pensioners (art. 1, Presidential Decree 180/50)⁵. Repayments are amortized over a maximum of 10 years, with fixed monthly instalments - not exceeding 20% of the net monthly salary or pension - withheld from the borrower's pension/payslip by the employer or pension institution and paid directly to the lender.

The specified amount of salary/pension is withheld following assignment of the receivable by the employee/pensioner in favour of the lender. In terms of characteristics of the transaction, a key factor is the "pro-solvendo" with recourse assignment of the related monthly receivable: employees/pensioners are only released from their obligations towards the lender if - and to the extent that - the lender actually gets the instalment that is equal to the portion of salary/pension that has been assigned.

In other words, for credit risk assessment purposes the lender evaluates:

- the employee/pensioner, as the "principal debtor" of the loan
- the employer or pension institution (depending on the case) responsible for paying the salary/pension.

From a legal standpoint, these parties are "appointed third-party debtors" and, as such, are equivalent for supervisory purposes to parties that in substance guarantee the transaction.

1.2 *Guarantees in support of the transaction*

In addition to being guaranteed by this "replacement" of the debtor by the employer/pension institution, the law also requires the loan to be backed by other peculiar types of guarantee/instrument that mitigate the risk.

1.2.1 *INSURANCE POLICIES (ART. 54, PRESIDENTIAL DECREE 180/50)*

A life insurance policy must be arranged in favour of the lender that guarantees repayment of the residual debt upon death of the borrower.

In the event of assignment of one-fifth of salary or other assignments by the employee, a further policy must be arranged to cover unemployment risks and failure of the debtor to meet the loan repayment

⁵ Pursuant to art. 52 of Presidential Decree 180/1950, these loans can also be granted to employees on fixed-term contracts and those whose working relationships are governed by art. 409, point 3, of the Civil Procedures Code, on condition that: in the first case, the assignment period does not exceed the residual duration of the job contract; in the second case, the working relationship must be certain and continuous, with a duration of not less than twelve months. In this case too, the assignment period cannot exceed the residual duration of the contract. Given the above requirements for access to loans guaranteed by the assignment of one-fifth of earned income, the discussion presented in this document with respect to employees is equally applicable to workers on fixed-term contracts and those whose working relationships are governed by art. 409, point 3, of the Civil Procedures Code.

obligation upon termination for any reason (including dismissal and resignation) of the working relationship between the debtor and the employer.

The lender arranges both guarantees with (one or more) insurance companies paying in advance a single amount of money when the loan is paid out.

1.2.2 TRANSFER OF THE EFFECTS OF THE ASSIGNMENT FROM THE SALARY TO THE PENSION (ART. 43, PRESIDENTIAL DECREE 180/50)

In the event of termination of the working relationship before the loan has been repaid, the effectiveness of the assignment of salary is extended, by law, to the pension or other equivalent regular payments due to the debtor - as a consequence of termination of the working relationship - by the employer or by other pension or insurance institutions (depending on the pension scheme envisaged in the employment contract).

1.2.3 RESTRICTIONS ON EMPLOYEE SEVERANCE PAY (TFR) AND OTHER SIMILAR INDEMNITIES (ARTS. 1, 43 AND 52, 55 OF PRESIDENTIAL DECREE 180/50)

Under the law, it is not possible for an employee to assign employee severance pay (or any other indemnity due by an employer as a consequence of termination of the working relationship): in fact, the indemnity is solely available to satisfy the debt with the lender.

This aspect is confirmed by several rulings handed down by the Constitutional Court on questions about the partial seizure of TFR raised by borrowers (see ruling 99 dated 19 March 1993), and extending the seizure envisaged for the private sector (art. 545 of the Civil Procedures Code) to public employees as well.

Given these rulings, contracts explicitly envisage those provisions, informing consumers about these restrictions in favour of the lender in order to guarantee repayment of the residual debt following termination of the working relationship for any reason (including dismissal) during the loan repayment period. This privilege for the creditor also applies when the working relationship ceases without any right to a pension for the employee/debtor.

Certainty about payment of the employee severance pay is further strengthened by the rules that protect employees should their employer become insolvent (art. 8, Directive 80/987/EEC of 20 October 1980, transposed into Directive 94/08/EEC and two enabling laws: Law 297 of 29 May 1982, which established a specific Guarantee Fund, and Decree 80 of 27 January 1992, which extends this guarantee to include final salary payments - arts. 1 and 2).

If an employer becomes insolvent, the specific public guarantee fund (managed by the National Welfare Institution – INPS) pays the severance pay to the employee.

1.2.4 COLLECTION OF SUPPLEMENTARY PENSION FUNDS

Should the working relationship be terminated for any reason, including dismissal, the effects of the assignment also extend to any supplementary pension scheme arranged by the debtor.

In this context, the combined provisions of the following articles are applicable: art. 55 of Presidential Decree 180/50 "Applicability of the provisions of Title II - Extension of the effects of assignment to cases of termination – Exceptions"; art. 43, para. 3, of Presidential Decree 180/50 "Extension of the effectiveness of assignments to pensions and similar indemnities", and art. 61, para. 3, of Presidential Decree 895/50 "Obligations in the event of reduction, suspension or termination of emoluments", which governs termination of the working relationship prior to the end of the assignment period, without the employee being entitled to a pension.

Pursuant to art. 43, para. 3, of Presidential Decree 180/50, in such cases the effects of the assignment extend "up to the entire amount of the residual debt" to any amount due to the employee "for one-time

indemnities or sums assured due from the administration or a pension institution or an insurance company".

In this regard, art. 61, para. 3, of Presidential Decree 895/50 explicitly envisages that "before paying an indemnity or sum assured, the pension institution or insurance company must wait for the assignee, or the insurer or guarantor that stands in place of the assignee, to indicate the amount to be withheld from the indemnity or sum assured in order to cover the entire amount of the residual debt guaranteed by the assignment".

Again in this regard, when granting the loan, the bank notifies both the employer and any supplementary pension fund to which the employee belongs (pursuant to current legislation) about the "assignment contract" signed between the customer and the bank, which expressly mandates the latter to make collection by drawing against the pension fund.

Pursuant to art. 43. para. 3, of Presidential Decree 180/50, upon termination of the working relationship the bank notifies the residual debt guaranteed by the assignment to both the employer (so that it can be withheld from the retirement pay) and the supplementary pension fund.

Addressing specific questions about art. 61, para. 3, of Presidential Decree 895/50, the Pension Fund Supervisory Commission issued Circular 6526 dated 23 October 2009 specifies the procedures to be followed by supplementary pension funds when paying for individual positions in favour of lenders and this must happen with collection mandates given by workers who contribute the funds concerned.

This Circular states that "if the contributor (worker) of the fund has given a collection mandate, the lender may request payment if a situation arises giving entitlement to such payment", (such as - specifically - termination of the working relationship).

1.2.5 FORECLOSURE PROCEDURES FOR EMPLOYEE SEVERANCE PAY OR OTHER INDEMNITIES AND/OR SUPPLEMENTARY PENSION FUNDS

If the working relationship of the financed employee (whether public or private sector) is terminated, the foreclosure procedures should also be considered. In particular, it is necessary to check if retirement pay (and/or supplementary pensions) provide suitable security for the purpose of mitigating credit risk.

When the employment relationship is terminated, both the insurance cover and the legal provisions giving the bank privileged right on access to the retirement pay, any other one-time payments made to the employee and the supplementary pension account (if any) of the employee (arts. 43, 52 para. 1 bis 2nd sentence, 54 and 55, 2nd and 4th paras., of Presidential Decree 180/50 and 61 of Presidential Decree 895/50) work together.

In practice, the employer usually notifies termination of the working relationship and:

- Requests to the bank, in the same communication, for the amount of the employee's outstanding debt in order to pay over the due portion of the retirement pay, (usually during the month following that of termination); or
- makes a credit transfer to the bank withheld on retirement pay (and/or supplementary pension), up to the nominal residual amount of the debt (total of instalments due during the remaining repayment period) , without waiting for the final statement of the lender. In case the amount transferred exceeds the actual residual debt, the bank pays the excess amount directly to the borrower.

In addition, the bank:

- informs the insurance company about the outcome of the payments made by the employer and/or the pension institution (if applicable), in order to claim reimbursement for any loss represented by failure to collect the full amount due;
- sends a claim to the insurance company that covered the employment risk, indicating the residual debt of the employee;
- at the same time as making the claim, sends a statement of the residual debt to the employer and the supplementary pension fund (if applicable) pursuant to art. 61 of Presidential Decree 895/50, in order to obtain payment from the retirement pay and supplementary pension accumulated by the employee, up to the full amount due.

Accordingly, the bank firstly collects against the retirement pay and/or the supplementary pension fund and then, if this coverage is insufficient, requests reimbursement of the residual debt from the insurance company (that provided cover pursuant to art. 54 of Presidential Decree 180/50).

1.2.6 RESTRICTIONS ON SEIZURES AND ATTACHMENTS (ART. 68 OF PRESIDENTIAL DECREE 180/50)

If the salary or pension is subjected to seizures and attachments after grant of the CQS or CQP loan, the portion available for seizure or attachment is limited to the difference between half of the salary or pension and the amount assigned to repay the loan. The position of the lender is therefore expressly guaranteed⁶.

1.2.7 SPECIAL CASE: UNPAID LEAVE

Unpaid leave requested by the employee is governed by the combined provisions of art. 55 "Applicability of the provisions of Title II - Extension of the effects of assignment to cases of termination - Exceptions" and art. 35 "Reduction of wages or salaries that have been assigned" of Presidential Decree 180/50, which governs all situations that result in reduction or suspension of the employee's salary, including this case. Specifically, art. 35, para. 1, applicable to all employees (whether State or public/private sector) pursuant to art. 55, envisages that "if the assigned wages or salary" of the employee "are reduced by not more than one-third, withholdings of the established amount shall continue to be made".

Art. 35, para. 2 (regarding State employees) establishes that "Where the reduction exceeds one-third, the withholding shall not exceed one-fifth of the reduced wages or salary". In the case of non-State, public employees and private-sector employees, this situation is governed by art. 54 of Presidential Decree 180/1950.

Accordingly, if the salary is reduced by more than one-third, the monthly withholdings made by the employer are lower than the monthly instalment due, and will be recalculated in order not to exceed 20% of the reduced salary. The part not withheld during the period of salary reduction will however be recovered by the bank by extending the original loan repayment schedule, as is often envisaged in the loan contract.

If no remuneration is paid during the period away from work, the bank may suspend the loan repayments during the period of absence.

The suspension of loan repayments is subject to the instructions contained in the Bank of Italy letter dated 10 May 2010 (which refers to Bank of Italy letter 575754 dated 10 June 2009) - instructions that were reiterated during the consultation held by the Supervisory Authority on 20 December 2011 regarding "Past-

⁶ Excluding seizures for family support and amounts due to the State.

due, overdrawn and impaired exposures” - under which “the period of suspension of loan repayments does not automatically change the credit quality classification of the exposure”⁷.

By agreement between the parties, upon the restoration of salary payments, it is also possible for the bank to withhold the portion not withheld during the period of reduction or suspension of salary, via an additional withholding such that the monthly total does not exceed 20% of the salary concerned.

This situation almost always arises in practice given that, with respect to the salary of the employee at the time of the loan when the repayment instalment was calculated, the available amount has risen in the meantime due to inflation adjustments, promotions, contractual indemnities etc. In this regard, it is important to highlight that the minimum duration of contracts for the assignment of one-fifth of salary is 24 months, while their average duration is about 110 months. This period is fairly long and, accordingly, increases in salary are very likely to happen.

Moreover, in the event of early settlement of the loan for any reason (voluntary, renewal, death, termination of the working relationship), the due amount will be collected by the bank in the early settlement account (retirement pay, supplementary pension, insurance cover - see below).

Therefore, the very few cases in which borrowers request unpaid leave will be processed as follows: banks suspend the repayments – for the time of leave and continue to classify the loan exposure in the credit category applicable at the time of such suspension,- pursuant to the Bank of Italy and EBA’s instructions. Given the above, this situation does not represent a loss of the guarantees that support CQS loans⁸.

2 Credit risk: empirical evidence

2.1 Sample survey carried out by ABI

A sample survey carried out by ABI in February 2014 involved 11 operators⁹. CQS or CQP loans were analysed by borrowers’ categories (employees / pensioners) and by type of Appointed Third-party Payor/assignee (ATP).

The survey was preceded by a training survey, carried out during 2013, in order to refine the analytical methodology and the quality of data gathered. The scope of the survey was defined as follows:

CUSTOMERS

The following three macro-categories of customer were considered¹⁰:

- Pensioners
- State Employees
- Regional, Provincial and Municipal Employees

⁷ The Bank of Italy letter mentioned clarifies that "unless new objective elements emerge that induce banks, acting autonomously, to revise their assessment of the credit quality of the debtor or the position, during the suspension period the exposures classified as non-performing, watch-list, restructured, past due and/or overdrawn and impaired, past due and/or overdrawn but not impaired, and performing must continue to be classified in their original categories. For the entire period of the suspension, intermediaries must also suspend calculation of the number of days past due and/or overdrawn". These rules have been partially reviewed by EBA.

⁸ Note that, in some cases, insurance contracts also cover the "unpaid leave" event.

⁹ See notes 2 and **Errore. Il segnalibro non è definito.**

¹⁰ The training survey identified that the Employees of private firms are somewhat heterogeneous as a category and they were therefore excluded from the subsequent analysis.

The sample excluded loans involving transition from the category of employee to that of pensioner. Accordingly, the survey only included assignments arranged with customers who were already pensioners at the time of the loan. In this way, it was possible to classify more precisely the cases of default.

POSITIONS ANALYSED

Overall, more than 1 million positions/year and the related default events were surveyed during the three-year period 2010-2012. Table 1 summarises the distribution of the positions examined, classified by type of ATP and year.

Table 1 Number of outstanding positions examined, by type of ATP and year

	2010	2011	2012	Total
Pensioners	152,164	238,371	319,820	710,355
State employees	39,027	59,766	82,141	180,934
Regional, Provincial and Municipal Employees	25,307	37,013	47,616	109,936
Total	216,498	335,150	449,577	1,001,225

LOAN ARRANGEMENT DATE

The scope of the survey was limited to transactions arranged subsequent to 31 May 2007, being the date of INPS Circular 91¹¹. In order to make the data structure as homogeneous as possible, the survey considered solely loans arranged directly (excluding, for example, those included in credit portfolios purchased without recourse).

2.2 Default: definition

LOAN QUALITY

The definitions of credit quality and defaulting exposures included in the supervisory regulations¹² were adopted in order to measure the *Probability of Default* (PD) and the *Loss Given Default* (LGD).

The survey therefore used the following default classification for the loans covered:

- Past-due loans¹³
- Restructured exposures
- Watch-list /Arrears
- Non-performing

¹¹ See <https://www.inps.it/circolariZip/Circolare%20numero%2091%20del%2031-5-2007.pdf>

¹² See: Bank of Italy Circular 263 dated 27 December 2006 and subsequent amendments and additions (Title II, Chapter I, Section V, Weighting rules), Bank of Italy Circular 285 dated 17 December 2013 and Bank of Italy Circular 272 dated 30 July 2008 and subsequent amendments and additions (Section B.2 Credit quality).

See https://www.bancaditalia.it/vigilanza/normativa/norm_bi/circ-reg/vigprud,

http://www.bancaditalia.it/vigilanza/normativa/norm_bi/circ-reg/Circ_285_pub.pdf and

https://www.bancaditalia.it/statistiche/racc_datser/intermediari/segnalaz/norm_rif/sec_ban/Matrice_conti_272
These definitions are compatible with the provisions of arts. 163 and 164 and arts. 180 and 181 of Regulation (EU) 575/2013.

¹³ With reference to days past due (more than 180 days past due but not classified as watch-list or non-performing, and between 90 and 180 days past due), for the sake of prudence only “beyond 90 days” was considered without taking account of the different time bands envisaged in the regulations (see art. 178, Regulation (EU) 575/2013). Up to 31 December 2011, the 90-day limit was extended to 180 days (Circ. 263/2006, Title II, Chapter 1, Section VI, paragraph 1).

plus:

- Loans not in default ("*in bonis*", "*performing*")

THRESHOLD OF SIGNIFICANCE

When identifying default, a threshold of significance of 5% of the residual debt was considered when considering missed instalments and incomplete payments: accordingly, if this threshold was not exceeded, the loan was classified as *in bonis*¹⁴.

In addition, loans were also classified as performing when:

- exposure to the individual transaction at the time of default (EAD) did not exceed 100 euro¹⁵;
- in the case of partial payment of one of more instalments, regardless of frequency, the threshold of significance of 5% is exceeded by an accumulation of short payments, each amounting to less than 10 euro.

FACILITY LEVEL

The guarantees for this type of loan have features not available to other technical forms. As such, any defaults on other types of loan by the same customer can be considered to have no effect on credit quality. Accordingly, the definition of default applied here relates solely to CQS or CQP loans¹⁶.

2.3 Probability of Default (PD): definition and survey results

2.3.1 PROBABILITY OF DEFAULT: DEFINITION

The probability of default (PD) is the probability that a performing loan at 31 December of a given year is considered "in default" during the following 12 months. The (annual) PD was estimated with reference to the frequency of default events occurring in the three-year period 2010-2012.

The PD was calculated for each of the three years (2010, 2011, 2012). The following elements were considered in order to calculate the ratio of the number of loans classified as in default by year end (D) to the total number of loans not in default (performing) held in the portfolio at the start of the year (B) [PD = D/B]:

- outstandings at both the start and end of the year,
- outstandings at the start of the year and closed out (or defaulting) during the year,
- new operations started during the year and closed out (or defaulting) during the year.

2.3.2 EVENTS AND PROBABILITY OF DEFAULT: SURVEY RESULTS

PROBABILITY OF DEFAULT BY TYPE OF ATP AND YEAR

Table 2 shows the number of positions considered and the probability of default for each aggregate, determined for each ATP category and year considered.

¹⁴ See Bank of Italy Circular 272 dated 30 July 2008 and subsequent amendments and additions (Section B.2 Credit quality).

¹⁵ See Bank of Italy Circular 284 (18 June 2013) *Instructions for preparing reports on the history of losses recorded on positions in default*, page 5.

¹⁶ Consistent with art. 178, para. 1, final sentence of Regulation (EU) 575/2013

Table 2 Probability of default, by type of ATP and year

PD	2010	2011	2012	Totale
Pensioners	152.164	238.371	319.820	710.355
Average	2,13%	3,60%	3,09%	3,06%
State employees	39.027	59.766	82.141	180.934
Average	2,09%	3,52%	1,51%	2,30%
Regional, Provincial and Municipal Employees i	25.307	37.013	47.616	109.936
Average	2,71%	6,73%	2,00%	3,76%
Total	216.498	335.150	449.577	1.001.225
Average	2,19%	3,93%	2,69%	3,00%

The average **PD** was **3%**.

At the first level of aggregation (by ATP or year), the highest average levels related to *Regional, Provincial and Municipal Employees* (3.76%) and 2011 (3.93%). On the other hand, the lowest levels related to *State Employees* (2.30%) and 2010 (2.19%).

At a further level of analysis (looking at ATP and year together), the highest PD related to *Regional, Provincial and Municipal Employees* in 2011 (6.73%). The lowest level related to *State Employees* in 2012 (1.51%).

PROBABILITY OF DEFAULT BY INTERMEDIARY, TYPE OF ATP AND YEAR: ANOVA

As further analysis an examination of variances (ANOVA) was carried out to determine the separate contribution made by each of the three variables considered (*Intermediary*, *ATP* and *Year*). This analysis (results shown in Table 3) allows to consider simultaneously and independently the significance of the differences between the means in PDs .

In conclusion, the *Intermediary* represents a clear discriminatory factor and the differences observed in relation to the *Year* and the *ATP* are not statistically significant. Discussion with the intermediaries that responded to the survey highlighted certain differences in the IT processing of defaults and return to performing status in their databases, especially as a result of IT architecture upgrades and migrations¹⁷.

¹⁷ These processing differences are nevertheless decreasing, not least as a consequence of the reports required by Circular 284 *Instructions for preparing reports on the history of losses recorded on positions in default* (Bank of Italy - 18 June 2013), which apply to consumer credit loans from 2013.

Table 3 ANOVA of the PD, with three classification criteria (intermediary, ATP and year)

	Devianza	GDL	Varianza	F	p
Totale	0,0955	71			
Tra intermediari	0,0287	7	0,0041	4,08	p < 0.005
Tra anni	0,0036	2	0,0018	1,77	p > 0.05
Tra ATC	0,0028	2	0,0014	1,37	p > 0.05
Errore	0,0604	60	0,0010		

Tabella da tradurre

The insignificance of changes between years suggests the absence of a cyclical effect during the three years considered.

2.3.3 RETURN TO PERFORMING STATUS

It was possible to check the effect of returns to performing status, due to the special structure of the survey (carried out on individual positions).

In order to calculate the PDs, the survey considered three separate periods:

- 2010 (*in bonis* at 31/12/2009, default by 31/12/2010)
- 2011 (*in bonis* at 31/12/2010, default by 31/12/2011)
- 2012 (*in bonis* at 31/12/2011, default by 31/12/2012)

Having considered the significance of the "return to performing status", the possible cases identified by the survey are set out below.

RETURN TO PERFORMING STATUS AFTER A DEFAULT EVENT IN 2010

By definition, a position identified as in default during 2010 is considered as such at 31/12/2010. However, two events should be considered:

- a) the same position might have returned to performing status during 2011 and therefore considered performing at 31/12/2011 and, consequently, included in the sample for 2012. *In this case, the number of positions to be considered performing at the start of 2011 is greater than that identified.*
- b) the same position might have returned to performing status during 2010: in this case, the position was included in the PD calculation for 2010, but was also included in the sample for 2011.

RETURN TO PERFORMING STATUS AFTER A DEFAULT EVENT IN 2011

If a position was identified as in default during 2011 (i.e. in default at 31/12/2011), the fact that the survey terminated on 31/12/2012 means that the application of event a) above cannot be checked. However:

- a) a position that returned to performing status in 2012 would have been included in the sample (had it been extended to 2013)
- b) the position might have returned to performing status in 2011, and therefore been included in the sample for 2012.

It was therefore possible to consider the return to performing status of positions in default at 31/12/2011 and performing at 31/12/2012.

RETURN TO PERFORMING STATUS AFTER A DEFAULT EVENT IN 2012

The survey only covered the period until 31/12/2012 and could not identify the return to performing status of positions that defaulted during 2012.

PROBABILITY OF DEFAULT AND RETURN TO PERFORMING STATUS: SURVEY RESULTS

Table 4 shows the PDs as corrected for the returns to performing status¹⁸. This highlights:

- the average PD for each aggregate considered (see Table 2)
- the reconstructed average PD after considering the returns to performing status¹⁹
- the quantitative impact by aggregate of the return to performing status.

The average PD for the entire set of positions considered, as reconstructed following the returns to performing status, is 2.71% (compared with 3%).

At a first level of aggregation, the return to performing status had greatest effect on the new average PDs for *State Employees* (27.6%) and *2010* (32.6%). Given the need for an appropriate period of time for a return to performing status to occur and be identified, the impact on the average PD for *2011* was 9.9% and nothing for *2012*.

The survey suggests that (on average) **9.9% of defaults return to performing status during the year of insolvency** and that **a further 22.7% returns to performing status in the following year** ($32.6\% - 9.9\% = 22.7\%$).

Table 4 Probability of default after returns to performing status, by type of ATP and year

PD Return to performing status	2010	2011	2012	Total
Pensioners	152,164	239,186	319,820	711,170
Average PD (A)	2.13%	3.60%	3.09%	3.06%
Average PD Return to performing status (B)	1.74%	3.37%	3.09%	2.90%
Effect of return to performing status (1-B/A)	18.3%	6.5%	0.0%	5.3%
State employees	39,027	60,038	82,141	181,206
Average PD (A)	2.09%	3.52%	1.51%	2.30%
Average PD Return to performing status (B)	0.69%	2.51%	1.51%	1.66%
Effect of return to performing status (1-B/A)	66.9%	28.7%	0.0%	27.6%
Regional, Provincial and Municipal Employees	25,307	37,390	47,616	110,313
Average PD (A)	2.71%	6.73%	2.00%	3.76%
Average PD Return to performing status (B)	1.09%	6.33%	2.00%	3.26%
Effect of return to performing status (1-B/A)	59.6%	6.1%	0.0%	13.3%
Total	216,498	336,614	449,577	1,002,689
Average PD (A)	2.19%	3.93%	2.69%	3.00%
Average PD Return to performing status (B)	1.47%	3.54%	2.69%	2.71%
Effect of return to performing status (1-B/A)	32.6%	9.9%	0.0%	9.5%

¹⁸ As in Table 2, Table 4 shows the values for each aggregate considered, defined with reference to the ATP category and year. Note however that, due to the effect of returns to performing status, the number of positions at the start of 2011 exceeds that identified in Table 2.

¹⁹ The average is lower than previously for 2010 and 2011; the averages coincide for 2012, since it was impossible to reconstruct the dynamic described.

The PD for 2010 (as corrected for returns to performing status) decreases from 2.19% to 1.47%.

Considering the ATP and year together, the effect of returns to performing status is even more evident: for *State Employees* in 2010 the rate is 66.9% and the PD drops from 2.09% to 0.69%, while for *Regional, Provincial and Municipal Employees* in 2010 the rate is 59.6% and the PD declines from 2.71% to 1.09%.

PROBABILITY OF DEFAULT AND RETURN TO PERFORMING STATUS BY INTERMEDIARY, TYPE OF ATP AND YEAR: ANOVA

An analysis of variances (ANOVA) was carried out on the new aggregates, as reconstructed considering the returns to performing status, in order to evaluate separately the contribution made by each of the three variables considered (*Intermediary*, *ATP* and *Year*) to the differences between the new average PDs.

This analysis - the results of which are summarised in Table 5 - highlight, Again in this case, the significance of the *Intermediary* variable as the principal factor in the variances between the average PDs. However, the *ATC* variable is now also found to be statistically significant.

This supports the findings presented in Table 4, confirming the positive effect of the returns to performing status (most marked in relation to *State Employees*).

Table 5 ANOVA of the PD after returns to performing status, with three classification criteria

	Deviation	DF	Variance	F	p
Total	0.0784	71			
Between intermediaries	0.0225	7	0.0032	3.98	p < 0.005
Between years	0.0021	2	0.0010	1.28	p > 0.05
Between ATP	0.0053	2	0.0027	3.30	p < 0.05
Error	0.0485	60	0.0008		

2.4 Exposure at Default (EAD): definition

For the survey it was assumed that the *Exposure at Default* (EAD) was equal to the residual debt, including interest, and that the customer moved from performing status at year end to a state of insolvency at some time during the following twelve months. The amount of the EAD was prudently considered to be 100%, although this is an extreme hypothesis that assumes default at the start of the year, without any instalment payments during the twelve-month period observed.

2.5 Loss Given Default (LGD): definition and survey results

For the survey, the *Loss Given Default* (LGD) was measured with reference to all exposures with a default date subsequent to 31 December 2009 whose recovery procedures were considered completed during 2013. The *Aggregated Loss Given Default Rate* (LGDR_{Aggr}) for the year was identified directly by the survey respondent. This approach allows a weighted-average LGD to be determined for positions in arrears, regardless of their default classification (*Past due*, *Watch-list/Arrears*, *Non-performing loans*). Consistent with the instructions contained in the Bank of Italy's regulations, the *workout LGD* approach was adopted, which discounts the positive and negative cash flows associated with the recovery of defaulted positions. The definitions used in the survey to determine the *Loss Given Default Rate* (LGDR) for individual defaulted positions and the *aggregated LGD Rate* (LGDR_{Aggr}) are provided below. For individual defaulted positions:

- EAD (*Exposure at Default*) the amount of the exposure at the time of default
- RR (*Recovery Rate*) effective rate of recovery on individual insolvent positions, being the ratio between:

- RN (*net present value* at the time of default of the positive and negative cash flows associated with the recovery of the defaulted positions, obtained by summing the present value of recoveries and the costs of managing the position) discounted using the contractual interest rate (i^{20}) for the loan; and
- LGDR = 1–RR, (*Loss Given Default Rate*): portion (in percentage terms) not recovered.

The RN/EAD ratio represents the recovery rate (RR) for the defaulted position, the complement of which indicates the loss given default rate (LDGR). The methodology applies the following formula:

$$LGDR = 1 - RR = 1 - \frac{RN}{EAD} = 1 - \frac{\sum_t F_t^+ (1+i)^{-t} + \sum_t F_t^- (1+i)^{-t}}{EAD}$$

where:

- F_t^+ = Gross recoveries at time t, with t going from 0 (time of default) to T (closure date of the position)
- F_t^- = Costs associated with the individual position at time t, with t going from 0 (time of default) to T (closure date of the position)
- t = Date of the movement (collection or cost). Taking time 0 as the default date, t also indicates the elapsed time between the collection or payment date and the default date
- i = contractual rate.

The survey obtained the *Aggregated Loss Given Default Rate* ($LGDR_{Aggr}$) for 2013 for each type of customer (from the ATP). The Aggregated Loss Given Default Rate ($LGDR_{Aggr}$) for 2013 was determined (from the elements comprising the LGDR calculated for each individual position whose recovery procedures were completed during 2013) using the following formula:

$$LGDR_{Aggr} = 1 - \frac{\sum_p RN}{\sum_p EAD}$$

where p refers to the individual position and the summation relates to the aggregation.

SPECIAL CASES:

The survey applied the following instructions in relation to the certain special cases:

- POSITIONS RETURNED TO PERFORMING STATUS By convention in relation to positions returned to performing status, the recovery is considered to be the residual exposure
- POSITIONS CLOSED WITHOUT LOSS In this case, the LGD is zero (for example, non-performing loans recovered in full by drawing on the available guarantees)
- NON-RECOVERABILITY AND ANY COLLECTIONS With regard to loans specifically recognised as non-recoverable and those for which recovery action is uneconomic and therefore waived (events that close-out the loan), any collections obtained after adoption of the formal resolution are not taken into consideration.

RESULTS

Table 6 summarises the weighted average *Aggregated Loss Given Default Rates* ($LGDR_{Aggr}$) for 2013, as supplied by a sub-sample of respondents²¹ for each type of ATP.

In particular, the following values were used:

- total sub-sample positions outstanding in 2012

²⁰ In all cases, the interest rate used to discount the cash flows exceeded 9%.

²¹ The $LGDR_{Aggr}$ information was supplied by a sub-sample of 7 out the 11 participating intermediaries. The weighting was based on the number of positions in 2012 for each aggregate considered. The sub-sample represents ¾ of the total sample used for 2012.

- weighted average $LGDR_{Aggr}$, calculated for each aggregate considered
- range of variation of the $LGDR_{Aggr}$ for each aggregate considered, calculated as the difference between the maximum and minimum values of the $LGDR_{Aggr}$ communicated.

The weighted average of the $LGDR_{Aggr}$ is **5.79%**.

Higher average levels were found in relation to *Pensioners* (6.17%), while the minimum averages were observed in relation to *Regional, Provincial and Municipal Employees* (3.77%).

Greatest variability in the $LGDR_{Aggr}$ was found in relation to public employees (range of variation for all of about 10%).

Table 6 Aggregated Loss Given Default Rate ($LGDR_{Aggr}$)

LGDR_{Aggr} AVERAGE	2012
Pensioners	232,230
average	6.17%
Range (Max - Min)	8.99%
State employees	72,381
average	4.25%
Range (Max - Min)	10.32%
Regional, Provincial and Municipal Employees	38,103
average	3.77%
Range (Max - Min)	10.30%
Total	342,714
average	5.79%

Lastly, in order to determine the level of credit risk associated with loans guaranteed by the assignment of one-fifth of salary/pension, the *Expected Loss* ($EL = PD \cdot LGD$) and the *Risk-weighting factor* (RW)²² were calculated.

The following formula was used to calculate the RW :

$$RW = \left(LGD \cdot N \left(\frac{1}{\sqrt{1-R}} \cdot G(PD) + \sqrt{\frac{R}{1-R}} \cdot G(0.999) \right) - LGD \cdot PD \right) \cdot 12,5 \cdot 1,06$$

where:

- $N(x)$ = is the cumulative distribution function of a standard normal random variable (being the probability that a normal random variable with average 0 and variance 1 is less than or equal to x).
- $G(Z)$ = the inverse cumulative distribution function of a standard normal random variable (where the value of x is such that $N(x) = z$).
- R = the correlation coefficient, defined as:

$$R = 0.03 \cdot \frac{1 - e^{-35 \cdot PD}}{1 - e^{-35}} + 0.16 \cdot \left(1 - \frac{1 - e^{-35 \cdot PD}}{1 - e^{-35}} \right)$$

²² Consistent with the supervisory regulations and the provisions of arts. 159 and 154 of Regulation (EU) 575/2013.

Using the average PD and LGD data calculated from the sample of the responding intermediaries (subdivided with reference to the types of ATP considered), the respective values for EL and RW were calculated and presented in Table 7.

Table 7 EL and RW (calculated using the values for PD and LGD)

	PD	LGD	EL	R	RW	RW*
Pensionati	3,09%	6,17%	0,19%	0,07	9,2%	10,3%
Dipendenti dello Stato	1,51%	4,25%	0,06%	0,11	5,4%	6,5%
Dipendenti di Regioni, Province e Comuni	2,00%	3,77%	0,08%	0,09	5,2%	8,2%
Totale	2,69%	5,79%	0,16%	0,08	8,4%	10,0%

The average RW factor for the entire set considered is 8.4%, with an expected loss of 0.16%.

With regard to the type of ATP, the highest average RW factor was found in relation to *Pensioners* (9.2%, with an EL of 0.19%), while the lowest related to *Regional, Provincial and Municipal Employees* (5.2%, with an EL of 0.08%).

The final column of Table 7 shows the RW factor for an “*almost worst case*”²³, identified for each type of ATP with reference to the RW factor.

The RW* (almost worst case) factor in this case in 10.0%.

²³ The RW* of the *almost worst case* was identified as the 2nd largest value in the distribution of the RW factors of intermediaries (taking the highest remaining value after excluding the absolute maximum).

3 Conclusions: proposal for a specific supervisory treatment of Salary Secured Loans and Pension Secured Loans

SSL and PSL have evident characteristics that mitigate risk. As such, they deserve favourable prudential treatment with respect to alternative forms of consumer credit.

This consideration is supported by the results of a survey of the market riskiness of this technical form, which highlight the low level of credit risk with respect to other forms of retail loan. In particular, the survey showed that for the set of public employees and pensioners:

- the probability of default (PD) within 12 months is 3.0%
- there is a 32.6% return to performing status within one year
- the effective loss rate (weighted-average LGD rate) is 5.8%
- the expected loss (EL) is 0.16%
-

Accordingly, the theoretical risk weighting (RW) factor, calculated on the retail curve, is 8.4% (compared with the regulatory parameter using the standard method of 75%) significantly lower than current RW for retail portfolio.

Hypothesis 1**Annual depreciation of the value of the property: 4,2%.**

Value of the property: 1.000.000

LTV: 90%

Initial rent %: 10%

Lease term: 12 years

Amount of the loan: 900.000

Annual rentals

Exposure to corporate (tranche of the loan not covered by any type of guarantee is risk-weighted at 100%)

Use of standardised approach

	A	B	C	D	E	G	I	M	N	O	P	Q	R
T	Outstanding	Value of the property (4,2% annual depreciation)	50% value of the property (c)	Risk-weighted exposure - Basel 2 document and CRD IV-CRR (d) = (c*50%) +100% (a-c)	60% LTV (e)	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option A) = (c*50%) +100% (a-e)	Difference (g-d)	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - LTV	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - Risk-weighted exposure	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - Risk-weighted exposure (LTV threshold 50%)	Difference (n-d)	Option B_2	Difference (q-d)
1	848.822	1.000.000	500.000	598.822	458.364	619.640	20.818	85%	1.018.587	1.018.587	419.764	1.018.587	419.764
2	791.228	957.862	478.931	551.762	427.263	577.596	25.834	83%	949.474	949.474	397.711	949.474	397.711
3	731.734	917.500	458.750	502.359	395.136	534.166	31.807	80%	878.080	878.080	375.722	878.080	375.722
4	670.277	878.839	439.419	450.567	361.949	489.302	38.735	76%	804.332	804.332	353.765	804.332	353.765
5	606.792	841.807	420.903	396.341	327.668	442.958	46.618	72%	606.792	606.792	210.452	606.792	210.452
6	541.214	806.335	403.167	339.630	292.255	395.086	55.456	67%	541.214	541.214	201.584	541.214	201.584
7	473.472	772.358	386.179	280.382	255.675	345.634	65.252	61%	473.472	473.472	193.089	473.472	193.089
8	403.495	739.812	369.906	218.542	217.887	294.551	76.009	55%	302.621	403.495	84.079	403.495	184.953
9	331.210	708.638	354.319	165.605	178.853	241.783	76.178	47%	248.407	248.407	82.802	165.605	-
10	256.540	678.778	339.389	128.270	138.532	187.274	59.004	38%	192.405	192.405	64.135	128.270	-
11	179.407	650.176	325.088	89.704	96.880	130.967	41.264	28%	134.555	134.555	44.852	89.704	-
12	100.000	622.779	311.389	50.000	54.000	73.000	23.000	16%	75.000	75.000	25.000	50.000	-
Sum of risk-weighted exposure							559.976				2.452.956		2.337.040
Sum of risk-weighted exposure (LTV threshold 50%)											2.553.830		

Hypothesis 2**Value of the property constant over lease term**

Value of the property: 1.000.000

LTV: 90%

Initial rent %: 10%

Lease term: 12 years

Amount of the loan: 900.000

Annual rentals

Exposure to corporate (tranche of the loan not covered by any type of guarantee is risk-weighted at 100%)

Use of standardised approach

	A	B	C	D	E	G	I	M	N	O	P	Q	R
T	Outstanding	Value of the property (4,2% annual depreciation)	50% value of the property (c)	Risk-weighted exposure - Basel 2 document and CRD IV-CRR (d) = (c*50%) +100% (a-c)	60% LTV (e)	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option A) = (c*50%) +100% (a-e)	Difference (g-d)	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - LTV	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - Risk-weighted exposure	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - Risk-weighted exposure (LTV threshold 50%)	Difference (n-d)	Option B_2	Difference (q-d)
1	848.822	1.000.000	500.000	598.822	458.364	619.640	20.818	85%	1.018.587	1.018.587	419.764	1.018.587	419.764
2	791.228	1.000.000	500.000	541.228	427.263	577.596	36.368	79%	949.474	949.474	408.246	949.474	408.246
3	731.734	1.000.000	500.000	481.734	395.136	534.166	52.432	73%	731.734	731.734	250.000	731.734	250.000
4	670.277	1.000.000	500.000	420.277	361.949	489.302	69.025	67%	670.277	670.277	250.000	670.277	250.000
5	606.792	1.000.000	500.000	356.792	327.668	442.958	86.166	61%	606.792	606.792	250.000	606.792	250.000
6	541.214	1.000.000	500.000	291.214	292.255	395.086	103.872	54%	405.910	541.214	114.697	541.214	250.000
7	473.472	1.000.000	500.000	236.736	255.675	345.634	108.898	47%	355.104	355.104	118.368	236.736	-
8	403.495	1.000.000	500.000	201.747	217.887	294.551	92.804	40%	302.621	302.621	100.874	201.747	-
9	331.210	1.000.000	500.000	165.605	178.853	241.783	76.178	33%	248.407	248.407	82.802	165.605	-
10	256.540	1.000.000	500.000	128.270	138.532	187.274	59.004	26%	192.405	192.405	64.135	128.270	-
11	179.407	1.000.000	500.000	89.704	96.880	130.967	41.264	18%	134.555	134.555	44.852	89.704	-
12	100.000	1.000.000	500.000	50.000	54.000	73.000	23.000	10%	75.000	75.000	25.000	50.000	-
Sum of risk-weighted exposure							769.831				2.128.738		1.828.010
Sum of risk-weighted exposure (LTV threshold 50%)											2.264.041		