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For publication

UniCredit reply to the BCBS consultation on “Capital floors: the design of a framework based on standardised approaches”

UniCredit is a major international financial institution with strong roots in 17 European countries, active in approximately 50 markets, with over 7,500 branches and over 130,000 employees. UniCredit is among the top market players in Italy, Austria, Poland, CEE and Germany.

Main highlights

The Basel Committee has embarked on an RWA variability agenda, which includes, along with the consultation on capital floors, the revision of the standardized approach for credit, market and operational risk.

These regulatory initiatives integrate the huge number of reforming proposals aimed at transforming the overall Capital Framework (i.e. beyond the standardized approaches on credit, market and operational risk, we recall - among the others - the revision of the securitization framework, the harmonization of the Internal Model Approaches, the Leverage Ratio, Liquidity prudential requirements, TLAC). *Sic stantibus rebus*, at the moment it is really challenging to properly assess and quantify the impact of capital floors, based on standardized approach, on capital, portfolios and business models: first, the information on calibration is not yet available, second it is currently impossible to assess the intrinsic link between their setup and other regulatory proposed changes, many of which are still in the process of being finalized.

According to the Basel Committee of Banking Supervision's (BCBS) Consultation paper, the need to revise the transitional capital floors envisaged by the BIS 1 framework arose from the observed lack of comparability and reliability of the risk-weighted capital ratios calculated by the banks. Whereas UniCredit shares BCBS's concerns, UniCredit is of the opinion that capital floors should be evaluated at a later stage, after having clearly assessed the impacts of all the other regulatory measures already ongoing in order to carefully address the risk of decreasing the risk-sensitivity of Basel capital framework.

In this context, UniCredit discloses below the key concerns on the capacity and effectiveness of capital floors to achieve the stated goals as developed in the Consultation Paper.

- a) Mitigate Model Risk and measurement errors:** according to BCBS, capital floors have been designed, among others, with the aim at mitigating model risk due to such factors as incorrect model specification, measurement error, data limitations and structural changes that may not be captured in historical data. In UniCredit's view, this issue is already addressed by the current regulatory framework for internal models, which requires for all risk models to adopt measures and/or margins of conservatism aimed at addressing potential errors of estimations (i.e. Market Risk multiplying Factors, CCR methodology, AVAs).
- b) Address incentive-compatibility issues:** according to BCBS, banks have incentives to use overly optimistic internal models to reduce risk-weighted assets and thus maximizing the return on equity. Hence the capital floors aim at lowering this risk of arbitrage. UniCredit would like to point out that the regulatory framework of

internal models already provides a number of requirements aimed at reducing and controlling the room for arbitrage on RWAs. The set-up and implementation of a well-ruled internal control systems (e.g. Internal Validation and Audit functions perform onsite assessments on a continuous basis), the internal corporate governance requirements to ensure the oversight of internal models framework, the organizational requirements on the integrity of rating assignment processes, are some examples of the actions taken to mitigate the risk of arbitrage. In addition, Supervisors periodically assess the fulfilment of such requirements and any material internal model change (in terms of RWA decrease) need to get the prior approval of Supervisors before implementation.

- c) **Enhance comparability of capital outcomes across banks:** according to BCBS, capital floors would contribute to provide a standardized assessment of risk that is more comparable than the internal model-based outcomes. In UniCredit's opinion, it is quite unclear how capital floors would facilitate the achievement of such objective. UniCredit does not see a benefit in publishing standardized measure of RWA in comparison with the one calculated with the internal models because this would unintentionally lead to crowd out the internal model based measures (more complex in their mechanics, but also more accurate and risk sensitive) at the detriment of sound risk management. UniCredit strongly believes that the objective of simplicity will be more effectively achieved through the harmonization of modeling approaches and practices. This is a more effective way to eliminate undue variance while preserving risk sensitivity rather than by putting in place capital floors that in the end may be ineffective in detecting the underlying risks.
- d) **Complement the leverage ratio:** when BCBS firstly introduced the leverage ratio, the rationale was primarily that it would serve as a backstop to the risk-based capital measures, a constrain towards excess leverage in the banking system and an extra layer of protection against model risk and measurement errors. Therefore, if the floor is introduced with the objective of complementing the leverage ratio, then a sort of cyclical self-reinforcing trend towards higher capital requirements could be triggered with no real connection with underlying risks.
- e) **Reinforce risk weight capital framework and promote confidence in the regulatory capital framework:** the risk models can contribute to the financial stability only if the right incentives are provided, motivating the banks to afford the relevant additional costs to build and maintain internal models, considering also the governance, processes, IT systems. In UniCredit's view the most recent wave of prudential reforms is not encouraging banks to set up and retain IRB models, while the capital standardized approach is not the most efficient solution for strengthening capital framework and restoring market confidence. This reform could lead banks to give up internal models (due to lack of incentives and high costs). It is recently perceived by Regulators that internal models are deployed by banks with the aim at reducing capital requirements instead of being utilized as a more risk sensitive measurement system: this is the real threat to the credibility and reliability of the capital framework.

Moreover, we would like to go through some additional concerns:

- a) **Effects of the increasing capital requirements for bank's business:** A scenario where the cost of capital is unduly higher than the return on equity may cause banks to selectively deleverage and orient towards riskier products and clients, in order to improve overall profitability. Low risk products and clients would be the most affected. The further increases in capital requirements may lead to a loop of increasing capital issuance, which then would result in dilution and lower investor returns, increasing the cost of future financing.
- b) **Financial stability and herd behaviour:** a certain degree of variation in RWAs is a natural by-product of a

framework that attributes value to differences in portfolio segments and strategies, business models, and a bank's proven risk management and recovery practices. Similar portfolios can embed different risk profiles because of different portfolio concentrations, product focus, or the strength of the client-bank relationship. Some banks are simply more successful in managing problematic clients than others, which is reflected in their LGD models. In addition, credit risk management (and models) requires an expert judgment and it is vital to a sound system in which risk and business managers are required to critically assess individual risks rather than blindly implementing a common view. All of these differences are desirable. Banks developing different views on the risk profile of their customers contributes to financial stability by avoiding herd behaviour.

- c) **Securitizations:** Flooring securitization capital and requiring banks to implement both a Standardized Approach and one of the approaches higher in the securitization hierarchy (first in hierarchy the IRB Approach, second the RBA – Rating Based Approach) could defy the purpose of any effort to introduce a preferential treatment for simple, transparent and comparable securitization transactions. This treatment is being considered for the explicit desire to promote (good quality) securitization, which is seen as a key-contributing factor to economic growth.

For all the above mentioned points, UniCredit is strongly convinced that it is vital to keep the existing capital floors based on BIS 1 regime until the combined effect of all the regulatory changes regarding capital framework and its relevant impacts can be quantified.

Also European authorities are actively participating in the international debate on the revision of the capital framework. UniCredit would also like to note that, according to the European Central Bank (ECB) and the European Banking Authority (EBA), although the high level of flexibility of the IRB framework has compromised comparability, the internal models have definitely proved to be a valid and risk sensitive approach to measure capital requirements, encouraging banks to implement sound and sophisticated risk management practices.

EBA, which already regularly performs benchmarking exercises as required by the European legislator, issued "The future of IRB approach" discussion paper on March 5th, aimed firstly at harmonizing the sources of variance of the IRB models among institutions (e.g. different treatment of defaulted assets, definition of default, parameters calibration, definition of low default portfolios), and secondly at increasing the degree of convergence of the supervisory practices, recognized as another source of divergences in the implementation of IRB approach.

In addition, ECB, already involved in benchmarking and backtesting the performance of the risk internal models, is planning to perform a transversal audit of IRB models as from 2015 for three years, in order to harmonize the unjustifiable RWAs national differences.

Answers to specific questions

Question 1: Assuming the respective floors were calibrated to achieve the same level of required capital, what are your views on the relative merits of a risk category-based floors and an aggregate RWA-based floor? What are your views on a floor based on exposure class?

Answer 1

As a general comment, following all the above mentioned considerations, UniCredit would discourage the introduction of the capital floors as envisaged in the Consultation Paper or, in any case, it would never support a floor calibration which overrides internal models approaches. The calibration could indeed results in too high requirements which might induce banks to drop internal model approaches.

Bearing in mind that the proposal set in the BCBS consultation could not be properly evaluated until the calibration is

known, UniCredit examined the three options of floors (i.e. aggregate, risk category based and exposure class based) **and concluded to be tentatively in favour of the aggregate floor**. The following merits of an **aggregate RWA floor** have been recognized:

- a) **It is simple and flexible**, meaning that it would leave room for internal (capital allocation and risk management) and external (analyst due diligence) processes in a dynamic way.
- b) **It is easy** to implement and to communicate to external stakeholders: it is similar to the kind of floors already in place under Basel 1, and its adoption would be more comprehensible for both banks and external stakeholders.

In UniCredit's view, a **risk category based approach** is more complex and costlier to implement, it does not allow a comprehensive risk evaluation, while it does not allow banks to offset across risk categories. Overall, a risk category based approach could create more distortions reducing capital risk sensitivity.

Concerning the **exposure class based floor** for credit risk, it is not clear what the real proposal would be. UniCredit is aware that BCBS is developing specific floors or similar binding measures within the modelling of risk parameters (mainly LGD and PD). UniCredit wishes to reiterate that the combination of all these floor measures generates unjustified capital requirements duplications.

Question 2: *What are your views on the relative merits of the two options for adjusting for differences in the treatment of provisioning for credit risk?*

Answer 2

Based on the text of the BCBS Consultation Paper and on the examples in Box 2, it is unclear how floor calculations would concretely work, how the adjustment for credit risk will be applied, and whether and how different risk categories will be involved. Given the fact that the choice of one option over the other is intrinsically linked to the mechanics of the calculations, the consultation paper currently does not provide sufficient information to assess the impact of both options and thus does not allow banks to develop a fully-fledged assessment. From UniCredit's standpoint the following **additional considerations should be duly taken into account by the Regulator** while defining the final standards:

- a) Regulators, supervisors and market operators are increasingly looking at the CET1 ratio to assess a bank's financial strength. For this reason it is worth to highlight the impact on CET1 ratio of the two proposed options for provisioning adjustment.
- b) Additional simulations are necessary to assess how the floor calculation mechanics will work in case of EL exceeding provisions (i.e. in presence of shortfall that qualify as direct deduction from CET1 in IRB banks).
- c) In the jurisdictions where IAS 39 applies, there is not anymore the kind of "general provision" that could be included in the Tier 2 capital. The combination of the accounting standards and of the Basel regulation for credit exposures implies the exclusion of future loan losses not yet borne, and the inclusion of losses already borne (even if they were not shown at the time of measurement), on the basis of past experience of losses on assets having a similar risk profile to the asset being measured. Hence, all the Loan Loss Provisions are referred to specific credit exposures and therefore cannot be computed in the Tier 2. Considering that different accounting practices could lead to different floor outcomes, it is important to supplement the practical examples, illustrated by BCBS in Box 2 of the Consultation paper, by simulating also the scenario that entails the described situation (please refer to the enclosed excel sheet in the Annex for an example of simulation).

With specific reference to **Option 1** UniCredit would appreciate a clarification on the following points by the Regulator:

- a) Our understanding is that the calculation of the standardized equivalent measure of capital should be performed solely for comparison purposes to determine ratios under the standardized approach (i.e. adjustments to capital resources are merely made to determine regulatory capital to calculate ratios under the SA). Is it correct?
- b) Have the Standard RWAs to be multiplied by a floor factor in order to determine the floored capital ratios, while no additional adjustment on the IRB RWA is envisaged?
- c) In case the ratios under standardized approach are higher than IRB ratios, are the standard equivalent measures of Total Capital and CET1, calculated with the floor, the ones used for regulatory and supervisory purposes?

Moreover, with specific reference to **Option 2** we would appreciate that the following points are considered/clarified by the Regulator:

- a) This mechanic is more similar to the one already in place under Basel 1 regulation, hence it seems easier and more straightforward to be applied and no parallel capital calculations are required.
- b) How would the RWA adjustment work in case of EL higher than Provisions (i.e. CET1 capital deduction RWA equivalent has to be added to IRB RWA)?
- c) How would the calculation of capital ratio after floor work? In box 2 it is stated that “the capital amount will not include any surplus provisions, as this is adjusted in the RWAs under this approach”. In case the floor is hit, does it mean that besides the RWA, also the Capital has to be adjusted for regulatory reporting purposes? Therefore, have the final capital ratios (to be reported and disclosed) adjustments both at the numerator and the denominator? In case there is a Shortfall, does it mean that this deduction must not be considered in the final capital amount?

In conclusion, given the incomplete information and even the uncertainty of interpretation of the example proposed in the Consultation Paper, we can only confirm that option 2 will be easier to implement and communicate, and may accommodate better disclosure.

Question 3: *Do you have any other comments regarding the design of the capital floor?*

Answer 3

The final calibration of both the Standardized and Internal Models approaches, and of capital floors, should take full account of buffers built into the capital system, such as systemic risk buffers, capital conservation buffers, GSIB buffers, and countercyclical buffers. The interaction between the leverage ratio, the buffers, and the capital floors should equally be part of this comprehensive analysis. Moreover, it is worth to clarify how they will be calculated under a capital floor, i.e. whether buffers will be based on a floored or un-floored RWA, and how Pillar 2 fits into the equation.

Moreover, regarding the choice of the standardized approach based on the jurisdiction in which the bank operates raises two concerns in UniCredit's view:

- a) It should be clarified what the approach would be in case of Banking Groups operating in various jurisdictions. Would the standardized approach at group level equivalent to the sum of the different standardized approaches implemented in the different jurisdictions in which the Banking Group operates?
- b) How does the proposal address the issues mentioned in the Consultation with reference to the existence of more than one standardized approach, the particular treatments requiring supervisory approval and the dependence on other qualifying criteria?

ANNEX - “UniCredit simulations of Option 1 and Option 2 for adjusting for differences in the treatment of provisioning”



RWA Floor Simulation
Option 1 and 2_UniCr

KEY CONTRIBUTORS

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

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