UniCredit

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UniCredit Group's reply
to the EBA 2012 02 on own funds

UniCredit is a major international financial institution with strong roots in 22 European countries, active in approximately 50 markets, with about 9.500 branches. UniCredit is among the top market players in Italy, Austria, Poland and Germany. In the CEE region, UniCredit operates the largest international banking network with around 4.000 branches and outlets. UniCredit Group is a market leader in the CEE region. Furthermore UniCredit was recently recognized as Global Systemically Important Bank.

GENERAL CONSIDERATIONS

- Provisions on **deductions** (e.g. dividend) must be more specific, also in terms of timeframe for the approval procedure, as they currently leave the door open to a high degree of discretion by the competent authority.
- There are many major concerns on **Deferred Tax Assets** (DTA) and **Deferred Tax Liabilities** (DTL) as well as Foreseeable tax charges which need further clarifications.
- **Write-down of Additional Tier I instruments** should be done pari-passu and pro-rata with common equity Tier I instrument The current text would effectively cause an inversion in the creditors' ranking, difficult to justify in terms of appropriateness and from a legal standpoint.
- Proposed provisions would result in **Additional Tier I** instruments to be much more expensive and with a restricted **marketability**: fewer investors would find attractive to invest in such an instrument where the temporary write-down would be effectively considered as a sort of quasi-permanent write off.
- The modality of computing **indirect participations** stemming from index holdings seem particularly complex.

SPECIFIC QUESTIONS

Q01. Are the provisions on the meaning of foreseeable when determining whether any foreseeable charge or dividend has been deducted sufficiently clear? Are there issues which need to be elaborated further? What would be your definition of foreseeable?

A: It would be useful if EBA could clarify whether this approach is valid for all quarters from March to September, or applicable only to June and

September only. In other words, it needs to be clarified whether the net profit of the period – if any – has to be computed in the Common Equity starting from March.

Article 2(4) provides discretion to the competent Authority if the internal dividend policy is issued containing the concept of "prudent basis" to determine the amount of deduction; it could be useful to better specify the meaning of "prudent basis". A similar clarification would be useful for the concept of "exceptional dividends".
As the article 24 of CRD IV states that "*EBA shall develop draft regulatory technical standards to specify the meaning of foreseeable when determining whether any foreseeable charge or dividend has been deducted*", it would be much helpful to have a more detailed illustration of these concepts.

Art. 2(7) seems to leave the door open to a high degree of discretion by the authority. Indeed, asking that the competent authority must check that all necessary deductions have been made before consenting the inclusion of interim of year end profits in CET1, might cause problems in case there are time misalignments between the need to include profits to CET1 for regulatory reporting purposes and the moment when deductions are actually accounted for and approved by the competent authority. In the same vein, the expression "under any other adjustments" might leave the door open to a high degree of discretion by the authority. To this extent, provisions must be more specific than the proposed formulation, also in terms of timeframe for the approval procedure. Moreover, there are 27 different national company law regimes, whose rules on dividend distribution differ substantially. These rules cannot presently be addressed by the "one-size-fits-all" EBA approach. Until a European company law regime is established , only a national administrative practice can take into account the specific features of the applicable national company law.

Q02. Are the provisions on the applicable forms of indirect funding of capital instruments sufficiently clear? Are there issues which need to be elaborated further?

A: The provisions are sufficiently clear.
A topic that needs to be better specified refers to controls: does the authority expect that particular controls need to be put in place to check such circumstances of indirect funding? It is not straightforward to understand if loans granted (e.g. to corporate companies) are used for indirect funding purposes. The main control which is feasible refers to the purpose of the loan, when overall credit evaluation is performed before the granting ("funds destination"). Even when considering the latter and excluding frauds, it does seem particularly easy to investigate issues related to this kind of indirect funding when granting a loan different from the ones with a specific utilization like import / export financing, immovable property financing, or others.

Q03. How do you assess the provisions on related parties in particular the requirement to assess that, on an ongoing basis, the related party has sufficient revenues?

A: The point is sufficiently clear. However to extrapolate the proceeds from capital instruments held from the “sufficient revenues” seems to be very difficult.
Moreover, it seems to us that also this topic could be addressed within the framework outlined above in the Question 02. It is our understanding that the meaning of the question, “sufficient” revenues of whatever third party (related or not) is analysed in the credit process for the evaluation of the counterparty creditworthiness, when the Probability of Default is assigned to clients, so that related funds are granted consistently. Hence, one of the specific requirements of the credit evaluation process is to guarantee a suitable analysis of “sufficient” revenues, or any other cash inflows as well as the transaction at “*arm’s length*”. In the event the term “sufficient” has to have another meaning, it would be very useful to have further clarifications. Nevertheless, the credit evaluation process towards related parties has usually more stringent requirements than the "normal" one, in order to avoid any possible favourable conditions applied to these counterparties than the generic clients.

Q04. Are the provisions on the limitations on redemption of own funds instruments sufficiently clear? Are there issues which need to be elaborated further?

Q05. How would you assess the impact of documenting decisions on redemptions?

Q06. How would you assess the cost impact of including in the provisions of the instruments criteria as listed in paragraphs 2 and 3?

Answer to Q 4, 5 and 6: No specific comment to be made, since Article 27(2) (b) and Article 73(3) refer to redemption of own funds instruments issued by mutual, cooperative societies, thus of limited interest for Unicredit.

Q07. Are the provisions on the deductions related to losses for the current financial year, deferred tax assets, defined pension fund assets and foreseeable tax charges sufficiently clear? Are there issues which need to be elaborated further?

A: Special attention is needed to further clarify the following aspects:

- Article 35, (3), (b) of the Capital Requirements Regulation (CRR) should be further specified. In particular the wording “Member State or third country permits the offsetting” is not clear. We fully welcome this provision, because it seems that there is not a link to accounting presentation. However, while most member states allow offsetting, the rule is different in each country.

- We also recommend to further elaborate EBA stance on Deferred Tax Assets (DTA) and Deferred Tax liabilities (DTL) raised at the consolidated level, since the treatment of such DTA-DTL are not currently clear. In our view, DTAs and DTLs recognised only for consolidation purposes should not be taken into consideration for the Capital calculation. DTL amount recognised only for consolidation purposes is in general higher than respective DTA amount, largely depending on Purchasing Price Allocation (PPA) under IFRS3 rules.

We do believe that treatment of DTA and DTL, for the purpose of calculation of regulatory capital, should be the same for each Members State irrespectively of the accounting regime provided by local GAAP and irrespectively of the local tax legislation. Accordingly, netting between DTA and DTL should not be dependent on the way DTA and DTL are presented in the balance sheet. In order to achieve this, it is crucial to develop a detailed definition of DTA and DTL for regulatory purposes, also by further specifying certain provisions concerning Article 35 of CRR.

Concerning Article 12 of EBA CP the provisions are clear. However, we do believe that further elaborations are required. Indeed, despite the fact that in article 12 there is no explicit statement that DTA and DTL are to be based on the accounting standards of each Member States, there are certain provisions (in paragraph 3 of article 12, it is stated that the amount of deferred tax liabilities is the amount which is "recognised under applicable accounting standards") which, together with a lack of clear definition of DTA and DTL for CRR purposes, seem to imply that the CRR rules rely on accounting treatment. If this is the correct interpretation, it is a matter of concern.

For those banks preparing the financial statements under IFRSs, the accounting treatment for netting DTA and DTL is set by IAS 12, which requires netting under certain predefined criteria, where the existence of a currently enforceable right to offset plays a role. Since ultimately the existence of a right to offset varies according to the local fiscal law, the outcome in terms of netting, for the same underlying transactions, might be different in various jurisdictions. For this reason, we believe that the usage of DTA and DTL accounting rules/treatment for the purpose of regulatory capital calculation can not be supported by us as it is against the level playing field.
It is necessary that the off-setting rules are the same in all EU Countries, through a Regulation or a Directive, in order to ensure the above said level playing field.

An alternative solution could be the definition of specific rules (including netting) for CRR purposes and to keep accounting treatment and CRR treatment separate.
The latter solution could be supported by the following reasons:

1) Under IAS 12, all DTAs rely on future taxable profit, where under CRR a category of DTAs that does not rely on future taxable profit (since they will be automatically converted into claims towards Tax Authorities) is identified;

2) Netting (further to the above mentioned comment):

   a. under IAS 12, when the requirements are met, netting "shall" be done and is therefore mandatory; under CRR rules, netting "may" be done and is therefore not mandatory;

   b. the requirements provided by IAS 12 are more and different from those stated in the CRR;

   c. DTAs not relying on future taxable profit seem not to be taken into consideration for netting purposes, since they are not deducted.

3) IAS 12 does not distinguish DTAs and DTLs on the basis of their nature/origin (but DTAs on Tax Loss Carry Forward or unused Tax Credit), while CRR requires to deduct DTLs on intangibles, pension fund assets directly from intangibles and pension fund assets, without off-setting them with DTAs. Therefore, under CRR, DTLs will have in any case a different treatment than the IAS 12 treatment;

4) it is not clear what "applicable accounting principle" means, since, in many Countries, IASs apply only for Consolidated Financial Statement purposes where Local GAAPs apply to Separate Financial Statement.

Q08. Are the provisions on the types of capital instruments of financial institutions, third country insurance and reinsurance undertakings, and undertakings excluded from the scope of Directive 2009/138/EC in accordance with Article 4 of that Directive that shall be deducted from the following elements of own funds sufficiently clear? Are there issues which need to be elaborated further?

A: The aim of the deduction of capital instruments issued by financial institutions [bullets (a) and (c) under Article 15, comma 2] is understandable and we agree from a regulatory perspective. However it represents – also when applying the current supervisory regulation – a burden to the computability of instruments issued by holding financial institutions. In fact, information gathering about the computability of such instruments in the issuers' capital, according to the local company law, is a difficult task (i.e. it would be assumed to be aware of the capital structure of such institutions). Hence, for sake of prudence and in order to avoid any over-estimation of the capital, such capital instruments will be probably fully deducted without considering their treatment by the issuer; related operating processes to be implemented in order to gather the needed information could be questioned by a fully-fledged cost-benefit analysis.

Moreover, regarding Article 15, comma 3, bullet (a), the topic of "third equivalent country" already represents a matter of interest. Our main questions are the following: (I) which institution should officially recognize the "third country" as "equivalent" for being allowed to take the country into consideration as "equivalent"?; (II) is it necessary to be granted a permission from the national regulator of the host country for the application of this equivalent treatment?

Q09. How would you assess the impact of operating a deduction from Common Equity Tier 1 items?

Answer to Q 8 and 9: No specific comment to be made at this stage.

Q10. Are the provisions related to the requirements for cooperative networks sufficiently clear?

A: No specific comment to be made, since Article 46(3)(b) refers to capital issued mutual and cooperative societies, thus of limited interest for Unicredit.

Q11. Would you agree on the types of incentives to redeem as described in paragraph 2? Should other types of situations be considered as incentives to redeem?

A: yes, we do agree on the types of incentives to redeem as described in paragraph 2. However, we believe that point (f) concerning *"a marketing of the instrument in a way which suggests to investors that the instrument will be called"* is a broad and generic statement too. We would expect it to be more clearly defined, especially in a technical standard. What does *"marketing in certain way"* exactly mean? Examples of permitted / non permitted marketing material should be provided in order to avoid any doubts and to make sure that instruments will be marketed in a consistent way across several countries / markets.

Q12. Are the provisions on the procedures and timing surrounding a trigger event and the nature of the write-down sufficiently clear? Are there issues which need to be elaborated further?

A: We believe that write-down should be done pari-passu and pro-rata with common equity Tier I instrument. As it is currently written, there could be a situation where Additional Tier I holders would effectively be subordinated to shareholders, with a risk of moral hazard: financial institutions might be incentivised to hold a level of common equity Tier I just above the minimum requirement (5.125%); in that case, any loss would be effectively borne by Additional tier I holders, which could see their instruments' value potentially written down to zero while common equity shareholders would be barely affected. This would effectively cause an inversion in the creditors' ranking, difficult to justify in terms of appropriateness and from a legal standpoint.

Q13. How would you assess the impact of the provisions to be applied to temporary write-downs and write-ups?

A: Additional tier I's write down could effectively happen before common equity is wiped out, while the write-up is discretionary, and in the best case scenario it would take a very long time for it to be written back up, being the write-up mechanism pari-passu and pro-rata with common equity instruments.
The impact of such provisions would result in Additional Tier I instruments to be much more expensive and with a more restricted marketability: fewer investors would find attractive to invest in such an instrument where the temporary write-down would be effectively considered as a sort of quasi-permanent write off.

Q14. Are the provisions on indirect holdings arising from index holdings sufficiently clear? Are there issues which need to be elaborated further?

A: The modality of computing indirect participations stemming from index holdings seems to be particularly complex. The structure-based approach requires the institution to be able to determine the maximum percentage of the relevant entity that is part of the index by means of the investments mandate of the index for estimating its exposure towards the entity (but – e.g. – in this case, how should be determined the deduction in case the fund mandate allow to invest up to x% of y possible different capital instruments? Should the deduction be requested for all of them? In these cases, the full deduction of the whole investment proposed by the Article 25 of EBA TS, comma 4, would be extremely burdensome. Other questions are: what is the right approach if the fund invests 50% in corporates' entities and 50% in financial institutions? Or what is the right approach if the fund invents both in capital and debt instruments?). A more simplified approach would be preferable.
Alternatively, e.g., we would also suggest an approach taking into account not only the overall ratio between net exposure and total own funds, but also the difference of investments in indexes between: (I) pure speculative position vs. (II) the aim to increase the stake into a relevant entity through massive investments in capital instruments of the index. By way of example, if – at the end of period – the issuer exceeds the ratio, it is asked to verify for which funds it holds more than a fixed percentage of the index's quotes (e.g. >50%) even if booked in the trading portfolio. In this case, it could be assumed that the business sense of the investment is associated with a stake increase in relevant entities. Hence the deduction of this investment could make sense. While, if the issuer holds a floating and relatively low percentage (e.g. from 0 to 50%) of the index, it appears to us that RWAs absorption on such investments could provide an indication of the speculative nature of the investment.
For the sake of completeness, we assume that such deductions are applicable only to indexes investing in financial instruments (and not synthetic indexes replicating the index's composition).

Q15. How would you assess the meaning of operationally burdensome and which circumstances would be considered as operationally burdensome?

A. If the "*low net exposure to the capital of the relevant entity*" means the overall amount of the investments in the index, without taking into consideration the investment mandate breakdown, it could make sense, even if it requires a considerable effort given the requested data. It could be simpler, according to our understanding, setting also an additional threshold with reference to the owned fund's quotes, as outlined in the example in Q14. Alternatively, if the "*low net exposure to the capital of the relevant entity*" is referred to the single name entity, the related operational effort seems to be too much burdensome.

Q16. How would you assess the cost of conducting look-through approaches vs structure-based approaches for the treatment of indirect holdings arising from index holdings?

A: Please see Answer 14 and 15.

Q17. How would you assess the levels of the thresholds for market making purposes (identical for hybrid instruments to the ones provided by CEBS/EBA guidelines on hybrid instruments published in December 2009) for competent authorities to give a prior consent (Article 29)?

A: Considering that such limits should be respected by front end operations, in UniCredit opinion these limits should be set in a straightforward way (e.g. fixed percentage of CET1), in order to avoid possible errors due to operations.
Hence, having said that, in case such limit are fixed according to a more complex algorithm, it would be useful to have a numerical example in order to allow us to give an opinion about the reasonability of the thresholds.
Moreover, please note that, with reference to Article 29(6) we would point out that it does not specify the thresholds for considering immaterial the repurchased amount in relation to the outstanding amount of the corresponding issuance after the call, redemption or repurchase has taken place.

Q18. How would you assess the impact of the proposed timing of 3 months for the submission of the application (Article 31)?

A: We agree with the proposed formulation, as it grants a uniform European perspective and a level playing field.

Q19. How would you assess the levels of the thresholds for the non-materiality of the amounts to be redeemed for mutual, cooperative societies or similar institutions (Article 32)?

A: No specific comment to be made, since Article 46(3)(b) refers to capital issued mutual and cooperative societies, thus of limited interest for UniCredit.

Q20. The EBA is considering setting a time limit the waiver shall not exceed. This time limit would be set up at a maximum of 5 years and a lower time limit could also be considered. Which time limit, within a maximum of 5 years, would you find appropriate?

A: The time limit of five years seems appropriate and coherent with the purposes of a financial assistance operation designed to reorganise and save the entity. To this end, it seems there are no reason to reduce the time limit of 5 years.
It could also be granted longer periods in case of specific situations, e.g. for particularly complex financial assistance operations, having a suitable plan approved by the competent authority(-ies).

Q21. Would you assess the limit on the amount of assets set at 0.5% of the average total assets of the special purpose entity over the last three years as appropriate?

A: Yes, we deem as appropriate a limit set at 0.5% of the total assets of the SPV.

Q22. How would you assess the impact of setting the limit at 0%, meaning keep only the possibility offered by point (a)?

A: Setting the limit at 0% would change the meaning of Article 78, with the risk of excluding Additional Tier I instruments issued by SPV even in cases where it is clear that the only assets of the SPV are the investments in the subsidiary's own funds.

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