

31 July 2015

UniCredit on Draft RTSs on Assigning Risk Weights to Specialised Lending Exposures (EBA/CP/2015/09)

UniCredit is a major international financial institution with strong roots in 17 European countries, active in approximately 50 markets, with almost 8,500 branches and over 147,000 employees at a Group level. UniCredit is among the top market players in Italy, Austria, Poland, CEE and Germany.

Main Highlights

Within the Internal Rating Based (IRB) approach for specialised lending exposures, the institutions, which are not able to estimate the probability of default (PD) or whose PD estimates do not meet the CRR requirements, are allowed by the CCR to assign the risk weights applying the *supervisory slotting criteria approach* as per the Basel framework. The adoption of the slotting approach is subject to the authorization of local competent authorities.

The EBA has the mandate (stemming from Article 153(9) CRR) to develop the regulatory technical standards (RTSs) to specify how institutions shall take into account the factors in assigning risk weights for institutions that are not able to meet the requirements for the IRB approach for risk parameters estimates; such factors are financial strength, political and legal environment, transaction and/or asset characteristics, strength of the sponsor and developer, including any public/private partnership income stream, and security package.

Specialised Lending exposures represent a significant part of the UniCredit portfolio which is mainly covered, within the IRB framework, either by parameters estimates of internally developed and validated models or by slotting criteria. For this reason, UniCredit welcomes the opportunity to provide its opinion concerning the EBA's consultation paper "Assigning risk weights to specialised exposure according to Article 153(5) CRR".

In general, UniCredit appreciates the EBA's initiative of outlining the RTSs in accordance with the CRR's mandate, especially in light of the ongoing revision by the Basel Committee of the Standardized Approach for Credit Risk. In fact, in UniCredit's view, the new Standardised Approach for specialised lending exposures promoted by Basel would envisage a uniform risk weight which would not reflect the actual level of risk and is even likely to have severe implications on infrastructure financing, and hence on the relaunch of some core sectors of the real economy, like real estate. The slotting approach is instead more risk sensitive than the standardized one, allowing that different factors are taken into account when assessing the creditworthiness of a counterparty. This opinion is also

consistent with the IIF's response to the Basel Committee for Banking Supervision's (BCBS) consultation paper "Revision for the Standardized Approach for Credit Risk", where it was clearly stated that, in respect to the flat and fixed risk weight envisaged by the BCBS's reform " [...] *More risk sensitivity should be sought where it is necessary and could be achieved in a relatively simple manner. In this regard, we propose that the slotting approach under the IRB should be considered for credit risk standardized approach to make the treatment of specialized lending more risk sensitive, rather than assign a uniform risk weight that does not reflect actual risks*".

Although the proposed slotting approach is preferable to the standardized one, UniCredit is nevertheless grateful to the EBA and **takes this opportunity to argue for the internal models as the favoured option**: notwithstanding the complexity of assessing model parameters for specialised lending exposures, large internationally active banks like UniCredit have rolled out models which have proved to be the most risk sensitive alternative and have consequently developed a comprehensive risk management framework made of methodologies, processes, procedures and functions, aimed at assessing the risk of their business in a punctual way. UniCredit is firmly convinced that internal models, when validated within the firm and authorized by regulators, are the very fundamental of a bank risk management process and should not be replaced by less risk sensitive measures, either standardized or slotting criteria approach.

In general UniCredit encourages the EBA to give careful consideration to the treatment of this exposure category, in the context of its ongoing work on the IRB approach as well as with respect to the discussions ongoing at international level to revise the Standardized Approach for Credit Risk.

Answers to specific questions

Question 1: *What are the operational challenges of using the slotting approach? Is it possible to obtain comparable capital requirements across institutions using the slotting approach? Should the slotting approach in your view be extended to other types of exposures, if yes, which types of exposures would this be particularly relevant for?*

Although across the UniCredit Group, internal models (e.g. Global Project Finance, Income Producing Real Estate (IPRE), Global Shipping, Wind Project Finance) have been developed to estimate the parameters of most of the specialised lending exposures, anyway the slotting approach has been already implemented by some banks of the Group for some specific portfolios. Consequently, within the IRB framework, if a bank could choose between estimating the parameters with the internal model or adopting the slotting approach, the introduction of the latter would not entail specific operational challenges.

Several reasons explain why UniCredit endorses the usage of internal models for this exposure class: firstly, they contribute to enhance expertise in different functions/processes of a bank (i.e. model development and validation, rating assignment, credit underwriting, monitoring and reporting). Focusing on rating assignment and underwriting processes, it is UniCredit's belief that internal models lead the bank risk analysts by tracking the risk assessment steps and figures.

Secondly, internal models limit the reliance of a bank internal risk processes on external inputs, like ratings estimated by credit rating agencies. For instance indeed, internal models allow for a prompt adjustment of in-house ratings, based on the outcomes of own monitoring processes. Obviously, this may have broader positive effects on risk related internal processes apart from regulatory reporting, such as risk appetite, risk based pricing, provisioning, credit portfolio models and economic capital.

In conclusion, UniCredit believes that the slotting approach is definitely effective where IRB firms are not able to meet the requirements to develop internal rating models and endorses the extension of slotting approach to immaterial classes of exposures, currently treated with the standardized approach, replacing flat, or completely risk insensitive, risk weights in order to improve the risk management practices. Anyway, in light of UniCredit's proved capability of engineering, implementing and maintaining internal rating models following the requirements of the CRR, UniCredit would dissuade the regulators from extending the slotting approach to other types of exposures for which the IRB Approach has been already authorized. In fact, the levels of capital a bank is required to hold under a slotting approach may not adequately reflect the level of risk taken, whereas the IRB Approach is more precise and ensures that capital levels are commensurate with the risks. Moreover, such approach could be used as starting point to trigger a more comprehensive risk assessment, leveraging on the bank internal knowledge of business and customers, instead of a regulatory standardized approach.

Question 2: *What would be the preferred approach for the combination of the factors into a final assignment to a category? What are the advantages and drawback of either approach? Are both options equally clear or should further guidance be provided? Are there other approaches that could be used to harmonise how the different factors are combined into a final assignment for the risk weight?*

UniCredit endorses the second option mainly because it is more risk sensitive than the first one. Option 1 is actually deemed as unduly conservative, since the assessment of a counterparty creditworthiness is tied only to the most problematic factor, without taking into consideration any other mitigating effect. The following table reports advantages and drawbacks for both options.

Option	Advantages	Drawbacks
1	<ul style="list-style-type: none"> - Simplicity (i.e. option 1 is easier to calculate) - It is conservative 	<ul style="list-style-type: none"> - One or only a few factors dominate the final assignment - Risk that not all factors are considered (thoroughly) when one factor is already classified in the highest category
2	<ul style="list-style-type: none"> - Similar to the general approach of an internal developed rating system (Weighting of product and customer information are used) 	<ul style="list-style-type: none"> - Huge management effort, similar to the one required by the IRB systems, in terms of development, validation and maintenance

	<ul style="list-style-type: none"> - Differentiated approach for assessing main factors of the specialised lending exposure - Possibility to fully integrate the expert based contribution granted by the slotting approach for the determination of risk weights for each factor - Better fits the logics of the underwriting process, where all the relevant elements are properly taken into account when assessing the counterparty overall creditworthiness. 	
--	--	--

In addition, in relation to the assessment criteria, UniCredit points out that some risk factors have the same answer for different categories and this could lead to a not correct assessment of factors. For instance in *Project Finance Exposure* (see annex 1), under *Financial Structure* in the *Financial Strength Factor* (ref. point d), there are two sub-factors which contain the same categories specifications. Hence, according to page 15 (5), UniCredit would suggest to introduce more differentiation in order to properly identify the risk category in case of overlapping sub-factors and in order not to create confusion. Furthermore, the combination of sub-factors (e.g. Market Condition, Stress Analysis, Financial Ratios) for each factor (e.g. Financial Strength)¹ should be better detailed, in particular the way to assign the weight of each sub-factor in terms of minimum or range of values.

UniCredit suggests that no minimum weight is prescribed, or at least that this minimum threshold is strictly above 0. Indeed, the introduction of a lower bound equal to 10% could penalize the assessment criteria for classes composed by several factors (e.g. in case of Object Finance there are 7 factors) because weights would have a very limited range of values. In addition, the proposed framework leaves anyway unmitigated the risk to assign a too high weight to some of them, attributing to only one or a couple of elements a disproportionate role.

Finally, referring to the specification of the combination of the different factors for the final assignment to a category, UniCredit would like to be clarified whether the simple integer scores assigned to each category (e.g. Category 2 = score 2) are binding or whether these scores are adjusted at a later stage and to which extent they are fixed or, vice versa, the banks will be autonomous in estimating their value.

Question 3: *Do you agree with the classification of specialised lending and the descriptions given?*

UniCredit agrees on the proposed classification, but it suggest to better clarify the definition of “third party” used under point c) on page 17. For example, a company is founded for the acquisition of assets. However, the income generated by these assets is lease or rental

¹ Annex 1 – Assessment criteria for Project Finance Exposures

payments obtained by the parent company and it is possible to lease or charter the assets to a different client any time. Is the parent company considered a third party in this case? Concerning point d) on the definition of “commodity finance” (page 17), it would be better clarifying the meaning of “reserves”.

Question 4: *Do you agree with these documentation requirements for each specialised lending exposure for which risk weights are assigned according to this Regulation?*

With reference to Article 3 – Documentation, page 17, UniCredit suggests that the list of documentation is supplemented with the rationale behind the rating assignment process and the reasons for overriding.

In case of option 2, UniCredit deems necessary to document the underlying process used to define the weights for factors and sub-factors.

Question 5: *Do you have any suggestions or comments on the assessment criteria for project finance?*

None.

Question 6: *Do you have any suggestions or comments on the assessment criteria for real estate?*

None.

Question 7: *Do you have any suggestions or comments on the assessment criteria for object finance?*

None.

Question 8: *Do you have any suggestions or comments on the assessment criteria for commodities finance?*

Due to the tight wording in the section “security package” (i.e. first ranking security interest providing legal control at all times), most activities would automatically fall under category 3 “Satisfactory” and therefore they would not benefit from a preferential RWA treatment, which in UniCredit’s view does not reflect the superior track record of commodity trade finance specifically in terms of loss given default based on the self-liquidating nature of the financing. A more commercially oriented definition would be warranted.

Question 9: *Do you have any suggestions or comments on the Impact Assessment?*

None.

Contact people (name.surname@UniCredit.eu)

Please find below the list of the key people involved in this work, whose contribution made possible to coordinate and provide UniCredit answers to this Consultation.

Coordination Team and Reviewer**European and Regulatory Affairs / Group Institutional & Regulatory Affairs**

Costanza Bufalini – Head of European & Regulatory Affairs

Micol Levi – Head of Regulatory Affairs

Andrea Mantovani – Regulatory Affairs

Maria Alessandra Martini – Regulatory Affairs

Contributors**Group Risks Modeling & Governance – GRM (Key Contributor)**

Giovanna Compagnoni – Head of Group Risks Modeling & Governance

Matteo Crippa – Head of Group Wide Rating Modeling & Governance

Boselli – Rating Governance and Advisory

Group Internal Validation – GRM (Key Contributor)

Lucia Ghezzi – Head of Group Internal Validation

Vincenzo Mole' – Head Group Wide Credit Risk & Architecture Validation

Paolo Capra – Head of Multinational Corporate & Group Wide Special Financing Validation

Project Finance

Massimo Pecorari – Head of Infrastructure & Power Project Finance

Gianfranco Sansone – Head of Infrastructure & Power Project Finance Italy

Real Estate

Stefano Tutinelli – Head of Corporate Structured Finance 2 Specialist (Italy)

Mauro Battaglini – Corporate Structured Finance 2 Specialist (Italy)

Object Finance

Holger Janssen – Head of Global Shipping (HVB)

Commodities Finance - Germany

Christoph Fischer – Head of Natural Resources (HVB)

Leasing

Stephanie Rewitz – Risk Management (GmbH)

Ulrike Jungnischke – Risk Management (GmbH)

Giovanni Vanellone – Head of Credit Risk Models & Tools (Italy)

Stefano Lisandrelli – Head of Credit Risk Internal Validation (Italy)

BankAustria

Stella Klepp – Regulatory Affairs (BankAustria Coordinator)

Helmut Gondor – Regulatory Affairs (BankAustria Coordinator)