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June 11th 2013

UniCredit Group's reply to EBA's Consultation Paper for the Draft Technical Standards on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements

UniCredit is a major international financial institution with strong roots in 20 European countries, active in approximately 50 markets, with about 9.200 branches. UniCredit is among the top market players in Italy, Austria, Poland and Germany and a market leader in the CEE region. UniCredit Group is acknowledged as a Global Systemically Important Bank.

Summary

UniCredit welcomes the possibility to comment on these Draft Technical Standards. Currently different regulation and/or practices are in place for assessing the materiality of extensions and changes of internal approaches. These Standards should sustain the regulatory harmonization in Europe.

UniCredit Group is currently authorized to the use of Internal Risk Based methods for credit risk in 11 Countries (34 rating systems, corresponding to approximately 50 internal models). In this framework, the Group faces different Supervisory practices, in some cases supported by issued local rules, which involve significant efforts in term of coordination of Home and Host Regulators requirements. As a consequence, UniCredit Group supports activities of higher harmonization of rules and practices in assessing the materiality of the IRB systems changes.

In the current Draft however, UniCredit denotes some areas for improvement, in particular:

1. in the case of material changes, it would be desirable to include a time-frame for the regulators' feedback to facilitate an orderly planning of model extensions and changes;

2. the thresholds set for AMA extensions and IMA extensions and changes seems rather low, an increase in the number of requests for authorisation can be expected;

3. for Market risk, the definition of "material" of any "changes to external data sources or the IT data landscape" seems too severe for minor IT changes;

4. for Credit risk, it is suggested:

    - to combine the qualitative criteria for "material" changes with a quantitative threshold based on which low material portfolios should be subject only to a notification regime; moreover, it should be recognized – as criteria for distinguishing material and not material changes - the role of second-level validation activities performed centrally in a Banking Group;.
    - to improve the definition of some qualitative criteria;
    - to define further rules (qualitative assessment) to mitigate the obligation to run quantitative impact simulation, especially in case of minor/immaterial changes.

General considerations:

The CRR – by establishing the principle of "prior permission" of the competent authorities for material changes – has introduced **a relevant change in current practices**, which are mainly based – in our experience – on notifications (e.g. communication of changes which implementation is possible after a defined period).

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UniCredit Group expresses**a general warning** on the risk of impact of the new framework in the **timeline** of introduction of model changes (with special reference to the credit risk systems). This could be especially important in case the changes are required to overcome highlighted weaknesses, since potential delays in their prompt and timely solution could be triggered – for example in case of material changes – by the need to assure an adequate period of time to the Supervisors for their assessments.

For the latter case, the draft RTS does not determine a **time-frame for the regulators' feedback** and/or authorisation. It would be desirable to include some form of limitation to facilitate an orderly planning of model extensions and changes.

Changes that can be notified after implementation should be reported "at least on an annual basis" to the Competent Authority (CA). Are there expectations in terms of timing ?

With reference to Credit risk in particular, we would like to express also the following considerations:

A) Preliminary Remarks on the Supervisory Processes

With reference to the current consultation, we would like to underline – as preliminary remark – that the assessment of the impact of the new rules is strictly depended not only on the **criteria** set for the materiality of extensions and changes, but also on the **supervisory process** required for the "prior permission" and "ex-ante notifications". Currently, no clear statement has been provided –in the RTS or through the Regulation – on the process that the Regulators will follow.

Moreover, EBA is required to develop in 2014 regulatory technical standards to specify the assessment methodology that competent authorities shall follow in assessing the compliance of an institution with the requirements to use the IRB Approach pursuant to Article 138: in our opinion, **criteria for material changes** and **supervisory assessment methodologies** are strictly interconnected and should be disclosed jointly and in a harmonized way.

The above is a relevant issue, for example, in case of group-wide systems applied through Legal Entities in different countries, for which the **process of joint decision** is required in case of first authorization: it is not clearly stated if the same process will be followed in case of "prior permissions" to model changes or for the evaluation of the "ex-ante notifications".

Considering the start-up of the Single Supervisory Mechanism, it is not clear which kind of process will be set up, both in case of first authorization and of material changes/ex-ante notifications, specifically in terms of coordination among ECB and local authorities and towards applications/material changes deriving from countries – even European ones - which decided not to join the SSM.

Even in case of ex-ante notifications, there is no clear view on the process, for example in case the Supervisor should decide for a more detailed assessment, with clear consequences on the implementation process and plans of the model changes.

B) Proposals for EBA's consideration

UniCredit Group supports the approach embedded in the RTS to clearly state criteria for the definition of material changes exhaustively and the risk oriented approach in distinguishing – in principle – changes of great or minor significance.
Nevertheless, we think that a **risk-oriented approach** should be more effective through the introduction of the following principles:

1. we suggest that a "material change" classification should depend not only on the qualitative criteria but also on the "materiality" of the involved portfolio. For example, model changes that are potentially "material" should be classified "ex ante notification" if they involve a residual portion of the Bank/Group portfolio.
   We underline the risk that the new discipline – which will involve considerable burdens not only for the Banks but also for the Supervisors – will put at the same level of importance the same type

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of change applied to a model which represents a very high or a very low % of the IRB Exposures or RWAs of the Bank/Group;

2. we suggest to consider the role of the second-level validation activities performed by a Central Function (being the first-level validation activity done at Local level): in case a "material" model change has been subject to a "second-level" validationprocess,, it should be considered an "ex-ante notification" change. In this sense the RTS should support the role of the Central Validation Functions, when they are structured with different levels/roles inside the Banking Group.

As far as the list of **qualitative criteria** for assessing the materiality of model/system changes is concerned, we underline the following points:

1. Part II, Title I (1) considers a change in the methodology used for assigning exposures to different exposure classes a "material change to a rating system". We think that this type of change – which happens rarely – is not connected to the scope of the RTS. A rating system information can indeed be used – together with other criteria - as condition to test the Asset Class assignment (for example in the Retail Asset Class), but a change in this framework can derive only from a significant change on the scope or range of application of the specific rating system which will be surely caught by the other rules set by the RTS.

2. Several qualitative criteria leave room for interpretation: for example letter f) of Part II, Title I and letter h) of Part II, Title II differ only for one word: changes in the **fundamental** methodology (material) and changes in the methodology (ex-ante notification). Even though we can expect a pragmatic approach of the Supervisors in applying the new framework, we underline that it is necessary to strengthen as much as possible the description of the criteria to ensure homogeneity in their interpretation.

3. Part II, Title I (2) (g): the inclusion of additional types of collateral into the LGD estimation is material if "their treatment differs from procedures that have already been approved": the statement isn't clear enough. Furthermore, taking in consideration also Part II, Title II 2 (j), are we correctly interpreting that even an additional type of collateral included in the LGD estimation, without changes in the methodological approach, should to be considered for the "ex-ante notification"?

4. Part II, Title II (2) (f): the inclusion of new or additional information in a model is considered a change to notify ex-ante; we think that this case can be better qualified in terms of relevance of the change (for example, a change in a single factor should be considered "immaterial").

5. Part II, Title II (7): even though a change in the use of risk parameters for internal business purposes could be relevant for notification, we underline that no reference to the tenor of the change is made (so, even immaterial changes should be notified?) and, moreover, that there is an incoherence with the "first application" framework, where the use of risk parameters for internal business purposes isn't ruled.

Q1: Are the provisions included in this draft RTS that specify the principles of categorisation of extensions and changes, sufficiently clear? Are there aspects which need to be elaborated further?

The provisions are sufficiently clear for Market and Operational risk. For Credit risk however we have the following comments:

1. The RTS specifies the range of application of the internal rating systems: reference is made to the type of exposures as defined in Article 137(1) no. 2 of CRR that may be rated with a specific rating system as defined in Article 137(1) no. 1). It should be specified if the RTS is applicable also in case of changes to authorized Internal Assessment Approach (see Art. 254 (3)).

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2. The RTS states that the quantitative impacts on RWAs shall be calculated for any changes (Art. 2 (2)) because the quantification of the impacts is one of the principles of categorization of changes; even though this is a current practice, it entails a relevant burden when required for all the changes, immaterial ones included, without taking in consideration other qualitative evaluations, such as the low materiality of the prospected impact of the change. We express our warning on the impacts that this requirement can deliver. As additional points to the prospected methodology (Art. 2 (2a and 2b) we would like to suggest:

   a. the introduction of a general principle according to which the “Backstop Threshold” isnot applicable to changes that the Institution qualifies in the third category (immaterial) based on the fact that the list of “ex-ante notifications” qualitative criteria is conservative enough in catching all the changes which can involve impacts such relevant to presume a “Backstop Threshold” check;
   b. the introduction of a general principle according which the “Backstop Threshold” isnot applicable to changes that the Institution qualifies in the “ex-ante notifications” category when an increase of the average risk parameters (PDs, LGDs or EAD) is prospected; in this case it is quite impossible to have a RWA decrease falling in the Backstop Thresholds.

3. Even if the ratio of the statement in Art.2 (3) (*avoiding slicing one change into several changes of lower materiality*) is clear, the reference to the assessment to be performed by the Bank may result in an excessive burden, with higher resources dedicated to collect and track changes over time. We suggest to establish the principle in the RTS, leaving to the Banks the responsibility to assure its ongoing application. For instance, UCG has set an Internal Rule that states that – for each planned model change – the development function proposes the classification (e.g. material, significant, immaterial) to the internal validation function which can confirm or override the classification. With this kind of process, the Bank can assure ex-ante the control of the application of the principle stated in Art.2(3), through the involvement of the internal control function with its proper role.The classification could indeed be confirmed or overridden also taking into consideration previous changes occurred after last regulatory assessment. In any case, the rule stated in Art.2 (3) should be introduced only with reference to the changes implemented after the official issuing of the present RTS (the tracking of all changes since the initial authorization will be excessively costly).

4. It is suggested to clarify that Permanent Partial Use authorizations/notifications are out of scope of the RTS.

Q2: Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the IRB approach sufficiently clear? Are there aspects which need to be elaborated further?

As far as the threshold set at Consolidated level is concerned, in Art.3 (2) and in Art. 4 (2), we suggest to recall the text of point (6) at page 11: the denominator should be the overall risk-weighted exposures amounts considering both Standard and IRB approaches.

Q3: Do you support the calculation proposal of the quantitative threshold for the IRB approach in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment)

For IRB Rating Systems we underline that in some cases the threshold based on RWAs may be not consistent with some specific rating systems, for example in case of Sovereign Rating Systems (where the RWAs are calculated in Standardized method for Permanent Partial Use application) or in case of models for Defaulted Assets portfolios.

Q4: Do you support for the IRB approach the three month period for notification of the changes before implementation?

As reported in the general remarks, we express our warning on the risk of impact of the new framework in the **timeline** of introduction of model changes, especially in case they are required to overcome weaknesses. A three-month period of notification of the changes before implementation will limit the institution’s flexibility of necessary risk management actions needed and we suggest a 1-month notification period instead.

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Q5: Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the AMA sufficiently clear? Are there aspects which need to be elaborated further?

Yes, the provisions are sufficiently clear.

Q6: Do you support the calculation proposal of the quantitative thresholds for the AMA in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment)

Annex 2, Part I, Title I, item (5) sets a threshold of 5% of the relevant indicator for AMA extensions. The Group believes this could increase the number of authorizations required in the industry; a 10% threshold could be more appropriate.
In fact, Table 1 on page 32 seems to indicate that all three Jurisdictions that have currently set a threshold, apply a higher one: Jurisdiction 1 applies a threshold of a 10% decrease of own funds, Jurisdiction 3 a 10% change in own funds, Jurisdiction 6 a relative change of over 20%in the model result.
We took notice that only one CA expects an increase in the number of authorizations (Impact assessment item 18. iii, page 38), but we expect that **at least** the three Jurisdictions above (1, 3, 6) potentially will have such an increase.
Moreover, AMA extensions are typically managed in roll-out plans that are shared and/or approved by the CA; therefor the CA is already informed well in advance of the planned extensions.

Q7: Do you support for the AMA the three month period for notification of the changes before implementation?

Yes.

Q8: Do you support that for the AMA no quantitative differentiation between changes requiring notification prior vs. post implementation is made?

Yes.

Q9: Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the IMA sufficiently clear? Are there aspects which need to be elaborated further?

Yes, the provisions are sufficiently clear.

Q10: Do you support the calculation proposal of the quantitative thresholds for the IMA in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment)

Title IV, Article 7, Item 1. sets the threshold for material extensions and changes at 5% of the own fund requirements or 10% of the model calculation result associated with the scope of application of the specific IMA model.
The Group considers these thresholds rather tight and asks to reconsider this setting, as:
- in general terms, it should be considered that VaR models have a certain degree of statistical uncertainty that could account for the “consumption” of a part of these thresholds;
- Table 1 (page 32) shows that all three current frameworks that have thresholds for material changes in place, apply higher thresholds: Jurisdiction 3 applies 10% of own funds requirements, Jurisdiction 4 uses 20%, Jurisdiction 6 applies a 20% change in VaR output;
- furthermore the Impact assessment item 19. iii, page 39, states that 70% of responding CAs expect no change in the number of authorizations, **but 30% does**. Overall we therefore expect an increase of the efforts by Banks and by Regulators.

We would also like to propose an additional threshold: the Material change as in Annex 3, Part II, Title I, item (4), “changes to external data sources or the IT data landscape” (page 27), should not be considered in all cases as “Material”, but only if the expected change in own funds requirements would

exceed a threshold of, for example 5% (thus more stringent than the higher general threshold we sponsor as explained above).
This to avoid the treatment of a rather minor change as “Material”; treatment that would imply request for authorisation, a long period of parallel run, on-site inspection, etc. In particular for Front Office systems this could be problematic. Our proposal implies that minor IT changes would be treated not as Material but as a change requiring notification before implementation.

Q11: Do you support for the IMA the one month period for notification of the changes before implementation?

Yes.

Q12: Do you support for the IMA the 60-day observation period for the purpose of comparing the modelling result before and after a proposed change?

Yes.

Q13: Do you support that for the IMA for those modeling approaches which are only required to be calculated once a week (stressed VaR, IRC, CRM) to compare only twelve numbers for Article 7 paragraph 1(c)(iii)?

Yes.

Q14: Do you support that for the IMA no quantitative differentiation between changes requiring notification prior vs. post implementation is made?

Yes.

Q15: Are the provisions included in this draft RTS on the documentation requirements sufficiently clear? Are there aspects which need to be elaborated further?

1. It should be clarified in point *d) technical and process documents* that process documentation is required only in case the change concerns processes (eg. Annex I, Part II, Title I (4) or Title II (4).

2. In case of changes classified as requiring notification before implementation, it should be clarified that point *e) reports of the institutions’ independent review of validation* can refer also to “assessment notes” specifically issued for the change in object.

3. It should be specified in point *g) quantitative impacts* that they are required when available (e.g. in case of process changes they are not produced).

4. In point f) (internal approval process) it should be considered that in some cases (especially in case of ex-ante notification) a relevant body can be a Head of Risk Management Function or a CEO, depending on the internal rules and not always a “Committee”.

5. Could you please clarify / elaborate on the expectations regarding item 1. h: “*record of the institution’s current and past version of internal models*;” ? In any case we suggest to avoid request of documentation which are not useful for assessing the change in request of approval or in notification. The available documentation, generally, already describes the main changes to the models over time.

6. Item 1. i. the requirement, when submitting a material change for approval, to provide a list and details of all extensions and changes planned for the coming 12 months that decrease (for IRB and AMA) or change (for IMA) the risk weighted exposure or own funds requirements, creates a series of questions:
   - what is the benefit for the CA to obtain such an overview, as each change should be judged alone and on its own merit?
   - priorities and time-to-delivery might change during the year; how binding would this plan be?

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- for certain changes it is not certain beforehand if an increase or a decrease would result, therefore for these changes (in IRB and AMA) it is not clear if these should be included or not in the 12 months' plan.

We suggest cancelling this point; even though the communication of planned extensions/changes is normally provided to the Supervisors at regular intervals, we donot understand why it is requested as support documentation to the specific model change notified or required for permission.

Q16: Do you support the view that costs arising for institutions from the documentation requirements included in the draft RTS are not expected to be material? If not, could you please indicate:

- the main cost driver: i) additional IT equipment, ii) additional ongoing Staff/hours, iii) other (please specify).

- the % increase in total yearly costs of internal models management for credit/operational/market risk induced by the proposed documentation requirements (specify whether the costs arise only for some of the risk categories covered by the provisions).

- indicative monetary amount of these additional costs (specifying currency and unit)

Operational Risk: with reference to our answer on Question 6, we can expect an increase of the number of "Material" changes and therefore expect an increase of coststo some extent, mainly in the form of additional staff / time effortto manage the process.

Market Risk: there is a rather long list with changes requiring ex-ante notification. Current practice does not foresee ex-ante notification for all these items and/or with less demanding documentation requirements. Hence we expect an increase of costs due to an increased number of notifications and more ample documentation, with staff / time effort as cost driver.

Credit Risk: In term of "documentation requirements" we don't see material costs arising.

Q17: Do you support the view that the additional costs, for institutions, of computing the quantitative impacts of the implemented model extensions/changes are expected to be non-material, given that institutions already carry out impact analysis in the current framework? If not please indicate:

- the main cost driver: i) additional IT equipment, ii) additional ongoing Staff/hours, iii) other (please specify).

- the implied % increase in total yearly costs of internal model management for credit/operational/market risk induced by the quantitative impact analysis (specify whether the costs arise only for some of the risk categories covered by the provisions).

- indicative monetary amount of these additional costs (specifying currency and unit).

Credit Risk: we support the view in case of acceptance of our suggestions in Q1 point 2). Otherwise we think that significant cost impacts can involve IT (costs for producing impact analysis) and HR.

Other risks: in the list of changes requiring ex-ante notification there are some minor items that are currently not necessarily quantified. Consequently there can be additional costs to some extent, mainly in terms of staff / time effort and IT for the quantification efforts.

Do you support the view that, for institutions, the costs of ex-ante/ex-post notification of extensions/changes are expected to be non-material? If not, please indicate:

- the main cost driver: i) additional IT equipment, ii) additional ongoing Staff/hours, iii) other (please specify).

- the % increase in total yearly costs of internal models management for credit/operational/market risk induced by the notification requirements (specify whether the costs arise only for some of the risk categories covered by the provisions).

- an indicative monetary amount of these additional costs (specifying currency and unit).

In order to qualify the prospected impacts we think that it should be clarified which Supervisory processes will be defined, as we reported in “General Remarks”. By introducing a new category of “prior permission” changes, we think that in any case there will be material costs driven by the Supervisory assessments (which may result very frequent in our case, considering the number of material IRB systems implemented).

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