12 March 2014

For publication

UniCredit reply to EBA consultation on on Regulatory Technical Standards on assessment methodology for IRB approach – EBA/CP/2014/36

UniCredit is a major international financial institution with strong roots in 17 European countries, active in approximately 50 markets, with almost 8,000 branches and over 130,000 employees. UniCredit is among the top market players in Italy, Austria, Poland, Central-Eastern Europe and Germany.

Summary

UniCredit welcomes the opportunity to comment on the draft Regulatory Technical Standards (RTS) on the assessment methodology for IRB approach.
The EBA document describes core areas within IRB framework which need to be assessed for suitability from Competent Authorities in the initial application as well as in the ongoing phases (e.g. in terms of governance, process, models, data quality and IT). As far as Unicredit Group experience is concerned such areas are overall consistent with usual assessment methodology applied by the regulator and therefore no major changes will need to be mirrored within Group practices as a result of this proposal (subject to a confirmation on specific topics below mentioned).
However Unicredit suggests to further elaborate some principles in order to ensure a consistent interpretation across banks and to avoid different appetites in the supervisory practices.
Moreover a clarification on the implementation timeline would be beneficial as for some prescriptions the compliance can be reached only gradually, consistently with a convergence path and roll-outs plan.

Answers to specific questions

Q1: What views do you have on the nature and appropriateness of the proportionality principle in Article 1(2)?
UniCredit agrees on the appropriateness of the proportionality principle, however it is not fully clear whether materiality and complexity should be the only elements to be taken into account as drivers for proportionality. The nature of the activity and risk profile of the exposures in question as an example are also extremely important elements to consider.
Further specifications are required with respect to smaller entities of a larger group. In particular, the proportionately principle, and therefore a lighter assessment framework, should apply in cases where these entities are not relevant within the banking group in terms of dimension (both absolute and relative to the overall group size).

Q2: Do you agree with the required independence of the validation function in Article 4(3) and Article 10? How would these requirements influence your validation function and your governance in general?
Unicredit agrees that the validation function should be independent from the credit risk control unit and internal audit, as well as from credit granting functions. We suggest to clarify whether the different organization frameworks described in point b), c) and d) of Article 10 are considered as equal alternatives or, on the other hand, an increasing demand for separation is required consistently with complexity/size of the Institution or according to the proportionality principle described in Article 1).

Q3: Are the provisions introduced in Article 49(3) on the calculation of the long-run average of one-year default rates sufficiently clear? Are there aspects which need to be elaborated further?
The RTS requires the time series length considered to calculate the long-run average of one year default rates to be representative of an entire economic cycle. More specific instructions should be provided in terms of definition of economic cycle and length of the underlying time series. This would grant consistency across Banks and supervisory practices.

Q4: Do you agree with the required number of default weighted average LGD calculation method introduced in Article 51(1)(b) and supportive arguments? How will this requirement influence your current LGD calculation method? More generally, what are your views as to balance of arguments for identifying the most appropriate method?
We agree on the on prescriptions related to Article 51. No impacts are expected.

Q5: Are the provisions introduced in Article 52 on the treatment of multiple defaults sufficiently clear? Are there aspects which need to be elaborated further?
We agree on the on prescriptions related to Article 52.

Q6: Are the provisions introduced in Article 60 on the treatment of eligible guarantors for the purpose of own-LGD estimates sufficiently clear? Are there aspects which need to be elaborated further?
Article 60 is not completely clear with particular reference to the text box. The meaning of "funded guarantee" should be elaborated as according to our views the guarantees are unfunded by definition.

Q7: Do you support the view that costs for institutions arising from the implementation of these draft RTS are expected to be negligible or small? If not, could you please indicate the main sources of costs?
An accurate evaluation of costs will be possible only after some clarifications and release of the final RTS. In this respect the expected implementation timeline is essential.

Q8: What are the main benefits for institutions that you expect by the adoption of these draft RTS?
The RTS can support the harmonisation of supervisory practice. However this can be reached only if rooms for interpretation are minimized.

Q9: Do you expect that these draft RTS will trigger material changes to the rating systems (subject of the RTS on materiality of model changes)? If yes, could you please indicate the main sources of the changes (please list the relevant Articles of these draft RTS)?
We do not expect that these draft RTS will trigger material changes to the rating systems. However firm conclusions can be driven only after some clarifications and release of the final RTS.

Further comments/clarification requests:

- A clear definition of "Institution" should be provided in case of large banking groups. Are the principles meant to be applied at Group level or at single LE level? (e.g. Article 10);
- Article 4: the concept of "Outsourcing" needs to be elaborated further to clarify that it only includes tasks that are performed outside the Group. For example rating system developed by a parent company or another group entity and used by subsidiaries of the group should not be considered as outsourced systems from the subsidiary's point of view;
- Article 8: it should be added among the verifications that the NCAs shall carry out also the assessment of the paragraph (1)(c) of the Art. 150 of CRR "*exposure in non-significant business units as well as exposure classes or types of exposure that are immaterial in terms of size and perceived risk profile*";
- Article 17:
  - o According to Article 17 internal audit (1)(a) reviews at least annually all the rating systems, the operations of the credit risk control function, credit approval process and the internal validation function in order to specify the areas of the annual work plan (1)(b) where it is necessary to carry out a detailed review of adherence to all applicable requirements referred to in Chapter 3, Title II, Part three of Regulation (EU) No 575/2013;
  - o UCG deems the mentioned *annual review* as corresponding to the annual Audit Risk Assessment activity during which, based on the results of the audits carried out, the tracking of the audit findings, the recommendations of the Supervisors, the regulation requirements etc… , the audit need of every single Rating System is evaluated in order to define the annual

and the multi-year Audit Plan. Accordingly, not necessarily every single rating system must be audited on yearly basis. This approach, being risk based, ensures that audit activities will be focused on the most risky areas and allows an efficient use of the audit resources guaranteeing at the same time homogeneous, flexible and conservative approaches while risk assessing all the models on the yearly basis.

- Article 22: UCG deems a period of grandfathering before the strict adoption of experience test requirement should be advisable, particularly regarding the presence of yearly validation and audit activities. Moreover, the milestones of the three year experience period should be clarified (particularly, it is not clear if the three years should be met at the time of first application date rather than of the first regulatory use);
- Article 24 (1)(g). It should be specified that the conservative treatment of missing data is needed only in case of actual lack of information, while in case of meaningful missing values the riskiness should be quantified according to empirical observations;
- Article 24 (2)(c). UCG agrees with the need for specific analysis aimed at assessing the performance of override process. However, more details should be provided with regard to "*the analysis of overrides per person applying the overrides*";
- Article 28:
  - o According to Article 28 (1)(c), when the institution applies the definition of default at the obligor level, once a default is recognised, all exposures to that obligor have to be recognised as being in default across the entire group. While we recognise that as much harmonisation as possible should be sought, we wish to recall that there are still national disparities, for instance in accounting and legal frameworks, that justify different treatments of default events. This can be especially true in case the default is due to an overdue in one Entity while in the other Entities the payments are fully regular;
  - o Art. 28 should explicitly state that, in case of retail exposure, the consistency of the default definition is not required among different segments: for example, within the "Other Retail" asset class, default can be defined at obligor level for SME customer and at transaction level for private individual ones. This view is coherent with other prescriptions, as the one stated in art. 65(1)(a) of the RTS itself: "*In assessing the assignment of exposures to the retail exposure class as referred to in Article 62(1)(c), competent authorities shall, in particular, verify that*:
    - *the institution distinguishes between exposures to natural persons and to SMEs based on clear criteria in a consistent manner*"

    Therefore, the institution is required to clearly distinguish between private individuals and SMEs, which represent two separate sub-portfolios in the same asset class. This reading is consistent with the general approach of Basel framework, aimed at ensuring the coherence between modelling and processes of the institution.
  - o Article 28 (3)(c)(i) states that the credit facility needs to be marked as being in default across all relevant systems within the institution. Please clarify if regulatory capital reporting systems are included. According to our view these should be excluded as regulatory capital reporting rules are currently defined under national rules.
- Article 33: a grandfathering period is advisable in order to allow banks to structure a process of data collection;
- Article 35(2): the RTS requires the evaluation of country risk among the risk drivers for non-retail exposures. However, for local (i.e. country specific) rating systems like Mid-Corporate the country risk is already embedded in the data used for development purposes. Moreover, some risk drivers suggested for retail exposures could be hard to update in the ongoing monitoring phase (e.g. personal income information are usually available only in the underwriting phase);
- Article 40(2)(c)(iii): the RTS require NCAs to verify that model structure and performance are not negatively affected by a default definition different between development and regulatory purposes. However, UCG recalls that in case of differences due to refinement to default definition (such as multiple defaults, stated by Art. 52, or technical defaults), performance assessment should be done according to same definition adopted for modelling purposes.
- Article 46 (revision of estimates)In our understanding of point (f) (*the data set used for the estimation of risk parameters includes the relevant data from the latest observation period, and are updated at least on an annual basis*) banks have to properly collect and store updated information, and test the performances of the models; if these performances prove to be adequate, models do not necessarily need to be updated. On the other hand, if models lose their statistical capabilities (but only in this case), the updated data sources will be used to refine or redevelop the models. Please confirm the correctness of this interpretation or if at least an annual recalibration is deemed necessary according

to this article;

- Article 51(1)(g): The statement "the capitalized unpaid late fees are added to the institution's measure of exposure and loss" should be elaborated further. It is not clear: a) whether those items should be always added to EaD or only when they are capitalized according to accounting practice; b) whether cash in from them should always be added to recovery cash flows or only when capitalized; c) whether only the fees capitalized before the default should be considered. Please note also that this topic could be influenced by different accounting practices among banks;
- Article 69 point c): more details on the expectations regarding this article are welcome. Is a stress test exercise on default rates or rating migrations need to be conducted in order to set the target PD during model development stage? If yes, how the results should be taken into account in the identification of long-run average one year default rates? Is the stress test to be considered as an additional validation tool?