22 January 2016

UniCredit reply to the EBA consultation paper on "Guidelines on the application of the definition of default under article 178 of regulation (EU) 575/2013"

Main highlights

When in 2015 the EBA launched the public consultation on the Future of the IRB approach (i.e. the Internal Ratings Based models), aiming at addressing the main sources of variance of the risk weighted assets (RWA) calculated by banks with internally developed models, UniCredit welcomed that regulatory initiative, deeply aware that it was vital to smooth the discrepancies between RWA across banks in order to ensure comparability without jeopardizing risk sensitivity. In that discussion paper, the EBA asked banks to sort the identified causes of divergences from the most to the less urgent.
At that time **UniCredit agreed that the definition of default**, **whose harmonization is fundamental to ensure consistency of application, and hence transparency and comparability, of credit risk parameters across banks, had to be prioritized**. Moreover, it was recognized that the definition of default materially affects the estimation of all the credit risk parameters, and hence it is even logical that it is dealt with at an early stage compared to other issues under review. Therefore, UniCredit now welcomes the opportunity to reply to this consultation paper, being also aware of the importance that a change in the default definition can have not only on the provisioning and the calculation of capital requirements, but also on the different bank processes e.g. credit monitoring, underwriting.

Further to this, besides the impact in terms of expected losses and RWA, clearly a priority for the EBA, **it is** also **important that the regulator weights the consequences for banks**, in light of the close relationship between the new definition of default and several internal processes. The investments needed to implement the proposed changes on banking processes as well as on the models, in case of IRB entities, might be highly costly. In this respect, the **right balance between the benefits from increased harmonization and comparability and the costs of implementation should be found.**

In this context **time is of essence**: the reshuffle of internal processes and IT infrastructure and the recalibration of the rating systems will require a strong effort in terms of time and resources and it is crucial that the **implementation timeline keeps into consideration the operational challenges** that in particular cross-border banking groups like UniCredit, which widely rely on internal models, will face to adapt to the new framework. In addition to operational complexities, it is **UniCredit's opinion that the adoption of these guidelines does not occur before the entry into force of the new IFRS 9**: since the harmonization of the regulatory and accounting standards is deemed as a primary issue, UniCredit stresses the need to synchronise both implementations, allowing banks to concurrently adapt to both new regulatory and accounting requirements in terms of definition of default. In this regard, not less importantly, UniCredit exhorts the EBA to keep into account the ongoing activity of the Basel Committee on the internal models revision when finalizing these guidelines, not to create inconsistencies in the IRB framework between global and European standards.

Even if UniCredit is overall supportive of the harmonisation purpose of the proposed guidelines, it is anyway

concerned on the **retrospective application of the new definition of default**, which will be operationally onerous and even in some case methodologically incorrect. Simplified data adjustments would become necessary with the risk to create inconsistencies and hinder the achievement of the desired level of comparability. Hence, UniCredit appreciates the EBA's proposal to provide banks with guidance. However, in light of the abovementioned operational challenges, UniCredit urges the EBA to directly involve the industry in a dialogue about the retrospective application and to which extent it could be applied.

Moreover, UniCredit would appreciate that the EBA clarifies how to calculate past due for some banking products such as mortgage loans: in our understanding the determination of default will be performed on a daily basis and not on the number of monthly overdue payments (as a proxy of the daily counting). This would mean that applying either FIFO or LIFO approach would have no impact on the default detection.

UniCredit is concerned that the EBA's proposal does not mention the possibility for banks to adopt a tailored approach for calculating past due of Public Administration entities, which would be legitimated by the peculiarities of this segment, often obliged to postpone payments due to administrative reasons. Since it is clearly stated that the default should be triggered only by credit-related events, UniCredit believes that the treatment of Public Administration needs to be reconsidered. **UniCredit's recommends indeed to suspend the counting of the past due days as soon as the obligor belonging to the Public Administration returns on at least one of its past due credit lines.**

With reference to the highly debated issue of **materiality threshold**, which is not subject to this consultation, but anyway intrinsically linked to it, UniCredit would like to recall an important comment made to the EBA's consultation paper "Draft Regulatory Technical Standards on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013" and then in the 2015 Quantitative Impact Study (QIS) on Definition of Default: the EBA data collection exercise requires to count the days past due starting from the breach of the Euro 200 absolute materiality threshold for the retail exposure, without any reference to the relative threshold. Likewise, this consultation mentions only an absolute materiality threshold for retail exposure, even being in contradiction with the abovementioned draft RTS. UniCredit does not agree with such an approach, expecting a material impact especially on the SME Retail portfolio. UniCredit hence firmly advocates that the **counting of days past due starts only once both the absolute and relative thresholds are breached for retail as well as for corporate exposures.**
In general **UniCredit would recommend the use of a unique materiality threshold for all asset classes**, firstly because obligors may shift frequently across different asset classes over time causing uncertainty in the default detection process and, secondly, because rating model segmentation is not aligned with asset classes definition, therefore one would have different materiality thresholds for obligors belonging to the same rating model.

In conclusion, there is another critical issue UniCredit takes the opportunity to draw the regulator's attention on, that is **the importance of granting banks with the right to compensate counterparty past due amounts with unused credit lines, ensuring the identification of only "genuine" defaults.**

Answers to specific questions

1. Do you agree with the proposed definition of technical defaults? Do you believe that other situations should be included in this definition? If yes, please provide detailed proposals on how to address further possible situations.

As currently set out, UniCredit finds the proposed definition of "technical default" unduly restrictive, with the risk that exposures, which are 90 days past due but not for a deterioration of the counterparty creditworthiness, would be improperly categorized as "pure" defaults.
The situations in which a technical default occurs, according to the EBA, miss the identification of all those cases which should be judgmentally assessed e.g. related to amounts that are disputed or waived.
For instance, in leasing business lines, a client could suspend payments not only for a difficulty to reimburse the bank but also for a management decision if a dispute occurs on the leased good.
The same might occur in factoring business: in case of a controversy on a supply, the debtor can decide not to pay the invoices, although his creditworthiness is unchanged.

Another case where there is a risk that a default could be identified even in absence of a credit event is when a customer has past due amounts on a line of credit and available margin on another one: in such case, the anomaly in the payment structure is likely to be due to a non-optimal management of the position. The possibility to net the past due exposure with the available margin would allow a proper identification of the amount affected by credit issues; moreover such a possibility would be more in line with the counterparty-level approach followed in this consultation.

Finally, in case of portfolios characterised by a higher frequency of technical defaults that do not result in credit issues, it would be beneficial also to have the possibility of identifying technical defaults on a massive basis rather than on a case-by-case, for example adopting a threshold in terms of number of days in default (e.g. days in default < 15 means the default is technical). Hence, if the past due lasts altogether for less than 15 days, it is considered technical and thus scratched. Otherwise, if it is more than 15 days-long, and hence it is a genuine default, it has been already daily correctly computed since its very beginning with no distortion in the past due amount calculation.

2. Do you consider the requirements on the treatment of factoring arrangements as appropriate and sufficiently clear? If not, please provide proposals for additional clarifications.

In case of factoring arrangements, where the risks and benefits related with the assigned receivables are fully transferred to the factor and the factor has exposures to the debtors of the client, it should be somehow clarified that both the absolute and relative materiality threshold is calculated only with respect to the 90 days overdue amount. This would imply to change current provision which states that the relative threshold is calculated as the ratio of the counterparty total overdue (regardless of the 90 days past due indication) and the total assigned receivables: if this threshold is breached and there is at least one receivable overdue for more than 90 days, the debtor is classified in default.

In Italy, where the repayment of the obligation is suspended because of a law allowing this option or other legal restrictions, it should be clarified how it works if the debtor is a public entity, considering that the payment date is not the one formally indicated on the invoice, but the one stated by the same debtor after a procedure of credit certification. Moreover, in respect to that date, the public entity has 30 days more to make the payment.

Also in case of factoring arrangements where the risks and benefits related with the assigned receivables are fully transferred to the factor and the factor has exposures to the debtors of the client, it should be also clearly regulated what happens in case the debtor disputes the receivables for any reason (e.g. receivables not existing at all or just partially existing, commercial supply not regular or different to the agreements, etc.). Theoretically, in these circumstances, the related receivables should be excluded from the calculation of the default status.

Finally, the EBA consultation does not discuss the case in which risks and benefits have been fully transferred to the factor, but the ceded debtor has not been informed of that (if the debtor has not been notified, he is not obliged to repay the obligations on the current account reported on the receivables and any payment of the debtor in favour of the assignor can release its obligations). For the sake of a clear regulatory framework, UniCredit would deem appropriate that the EBA covers this issue in the guidelines.

3. Do you agree with the approach proposed for the treatment of specific credit risk adjustments?

Although UniCredit believes the consistency of the default definition across credit institutions is a precondition to achieve level playing field and RWA comparability, the bank also considers it is important to ensure a homogenous application of the regulatory and accounting definitions within every single institutions.
Consequently, as a general rule, UniCredit agrees with an alignment with the IFRS principles and, in order to minimize the operational impact, deems fundamental to synchronise the entry into force of the new definition of default with the IFRS9, expected to occur in 2018.

4. Do you consider the proposed treatment of the sale of credit obligations appropriate for the purpose of identification of default?

UniCredit agrees with the general approach, but deems it is not clear on what basis EBA has proposed the threshold of 5% and would appreciate that the EBA provides evidence on the appropriateness of this level of calibration. This cap is very critical especially during a macro-economic financial crisis when the price of bonds can fall below 95% of their par value for reasons not strictly related to credit risk (for example due to an illiquid market).
Moreover, from an operational perspective, in case both credit and not credit-related factors contribute to the realized economic loss, it may not always be straightforward to distinguish which part of the economic loss is related to the deterioration in credit quality and then precisely computing the breach of the 5% threshold. Having said that, UniCredit would emphasize the importance of the expert judgement.

It has also to be taken into account that in case of sales of credit obligations 'en bloc', a flat rate is usually applied instead of one to one evaluation with no link to the real risk of the single transactions.

On the positive side, EBA is aware that an institution could be led to sell off credit obligations even in absence of a worsening of credit quality. Nonetheless, while the breach of the 5% threshold is an objective metric, it is more difficult to explain other strategic and business related evaluations which underlie the sale, and such lack of one-size-fits-all metric risks creating inconsistencies. For this reason, we would suggest setting up objective criteria to identify sales of credit obligations not related to credit risk.

Furthermore, the issue of the retrospective application of the definition of default becomes crucial in the context of the sale of credit obligations. Beyond the operational complexities cited at the beginning of this position paper, in this case the retrospective application is not even methodologically correct: it is likely that different factors would have been taken into account in the definition of the restructuring plan in case

such a rule had been in place. Therefore, UniCredit would stress the need to engage with the authority in a dialogue to discuss the limits of the retrospective approach.

Finally, UniCredit would appreciate a clarification by the EBA on whether securitized credits have to be considered within the "sale of credit obligation" category.

5. Do you agree that expected cash flows before and after distressed restructuring should be discounted with the customer's original effective interest rate or would you prefer to use the effective interest rate applicable at the moment before signing the restructuring arrangement? Do you consider the specification of the interest rate used for discounting of cash flows sufficiently clear?

For the sake of harmonization with accounting principles, UniCredit would support the adoption of the original effective interest rate. This being said, the fluctuations of the floating interest rates are seen as a critical issue, and UniCredit exhorts the EBA to clarify how they would handle it.

With reference to the 1% threshold, UniCredit deems it unduly low also in line with the article 178 (3)(d) of the CRR, which refers only to material forgiveness of the credit obligation. This is particularly true in light of the volatility induced by the fluctuations of interest rates mentioned above.

It is also not clear on what basis the EBA has introduced this proposal and UniCredit would like to be provided with the underlying evidences for the appropriateness of this level of calibration.
In addition, any effort to further harmonise the different thresholds preliminary set by the upcoming Regulation will be really appreciated (i.e. 1% on Distressed restructuring from DoD consultation; 5% threshold on the sale of credit obligation from DoD consultation – see Q4; 10% of credit related economic loss from the IFRS 9).

UniCredit would like to underline that the concept of distressed restructuring does not apply in case a revision of the conditions is allowed by the contract (e.g. embedded clauses) or by specific laws (e.g. moratorium issued by banking association/government).

6. Do you agree that the purchase or origination of a financial asset at a material discount should be treated as an indication of unlikeliness to pay?

UniCredit agrees that the purchase or origination of a financial asset at a material discount shall be taken as an indication of unlikeliness to pay (UTP). However, since the draft guidelines do set neither any quantitative threshold nor any qualitative metric to assess the "materiality" of the discount, UniCredit deems important to emphasize that the expert judgement is fundamental in performing such an evaluation as well as more in general in the classification of the unlikeliness to pay. Moreover, only the expert judgement can assess the credit-related rationale of the discount: if it is indeed not due to a worsened credit quality, it cannot be taken as an indication of unlikeliness to pay.

7. What probation periods before the return from default to non-defaulted status would you consider appropriate for different exposure classes and for distressed restructuring and all other indications of default?

For the past due amounts, a probation period of at least 3 months is already applied within many Group Entities in order to avoid frequent changes of status of exposures and, as a result, excessive number of

multiple past dues. However, UniCredit does not deem meaningful a probation period concept on UTP, in line with what stated in Article 178(5) of the CRR: "If the institution considers that a previously defaulted exposure is such that no trigger of default continues to apply, the institution shall rate the obligor or facility as they would for a non-defaulted exposure".

8. Do you agree with the proposed approach as regards the level of application of the definition of default for retail exposures?

UniCredit agrees with the EBA proposal. In particular, it is not deemed appropriate to have different default definitions applicable to the same customers. On the contrary, different default definitions could apply to different customers within the same asset class (e.g. Small Business vs Individuals).

9. Do you consider that where the obligor is defaulted on a significant part of its exposures this indicates the unlikeliness to pay of the remaining credit obligations of this obligor?

UniCredit deems that the proposed approach, even though reasonable, seems to push towards the obligor level approach, introducing more conservatism in the default detection rules set at facility level.

10. Do you agree with the approach proposed for the application of materiality threshold to joint credit obligations?

Overall, UniCredit agrees with the EBA's proposal. Nevertheless, it is important to underline that the identification of the joint full liability could be barely feasible for banks: the update of the information regarding the marital status is often complicated. For this reason, UniCredit would suggest removing the provisions of paragraph 85.

11. Do you agree with the requirements on internal governance for banks that use the IRB Approach?

UniCredit agrees with the EBA's proposal.

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. Several other experts have been involved alongside the UniCredit Group, but are not listed below.

COORDINATION TEAM

European & Regulatory Affairs - Group Institutional & Regulatory Affairs
Ms Costanza Bufalini – Head of European & Regulatory Affairs
Ms Micol Levi – Head of Regulatory Affairs
Mr Andrea Mantovani – Regulatory Affairs
Ms Maria Alessandra Martini – Regulatory Affairs

CONTRIBUTORS

Group Models Methodologies & Standards – Group Risk Management (Key Contributor)
Ms Chiara Francesca Capelli – Head of Group Models Methodologies & Standards and Regional Support
Ms Chiara Giordano – Group Models Methodologies & Standards and Regional Support

Credit & Integrated Risks Initiatives – Group Risk Management
Mr Giovanni Albanese – Head of Group Credit Risk Initiatives, Standards and Reporting
Ms Elena Fenili – Head of Credit & Integrated Risks Initiatives
Ms Elisabetta Longoni – Credit & Integrated Risks Initiatives
Mr Cesare Paulini –Credit & Integrated Risks Initiatives

Local Credit Risk Validation – Group Risk Management
Mr Vincenzo Mole' – Head of Local Credit Risk Validation
Mr David Latini – Head of Western Corporate Validation
Mr Tommaso Magenta - Western Retail Validation

Advice and Reporting – Accounting & Regulatory Reporting
Ms Chiara del Prete – Head of Advice and Reporting

Risk Management – UniCredit Factoring SpA
Mr Riccardo Aldanese – Head of Risk Management
Mr Stefano Sala - Direzione Crediti e Rischi

Risk Management – UniCredit Bank Austria AG
Mr Wolfgang Reitgruber – Head of Austria Credit Risk Models Development
Mr Thomas Veith – Risk Appetite and Integrated Risk Analysis

Risk Management – UniCredit Bank AG
Dr Andreas Maier - Rating Governance