

24 June 2013

**UniCredit reply to the EC green paper on
“Asset Encumbrance Reporting”
(ID number EBA/CP/2013/05)**

UniCredit is a major international financial institution with strong roots in 22 European countries, active in approximately 50 markets, with about 9.500 branches and more than 155.000 employees. 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, and is a market leader.

General Remark

The reporting requirements presented in this Consultation Paper will require significant efforts to be implemented. It is important that all the scope of application and the rules to identify correctly encumbrance are properly defined. It is also important that any overlap with other existing reporting requirement should be carefully analysed in order to ensure consistency of definitions and reduce reporting efforts.

Question 1: Is the definition of asset encumbrance sufficiently clear?

No, it is not clear enough.

EBA "encumbered" definition is relatively general than the vice versa "(un)encumbered" definition in the Basel III document (<http://www.bis.org/publ/bcbs238.pdf>, doc page 9) identifying substantially as encumbered assets the ones not free of legal, regulatory, contractual or other restrictions on the ability of the bank to liquidate, sell, transfer, or assign the asset).

The alignment of definitions of asset encumbrance for FINREP, COREP, Liquidity and Leverage ratio, both considering going concern and contingency/resolution scenarios, seems to represent one of the main target of the EBA consultative paper on “Asset Encumbrance Reporting under article 95a of the Capital Requirements Regulation (CRR)”. The asset encumbrance could be potentially defined following different criteria like:

1. the legal view to be further considered in light of civil/commercial/bankruptcy/fiscal laws;
2. accounting / regulatory principles;
3. economic view belonging to each contract type.

The definition proposed by the consultative paper seems not to clearly identify the criteria to be adopted for each contract type¹ and does not explicitly consider that different approaches may lead to different asset encumbrance definitions.

Asset encumbrance vs. Secured Funding approach

First of all it is crucial to clearly identify the distinction between asset encumbrance and secured funding; although ideally the two concepts should be symmetric, nevertheless, depending on the definition

¹ For example:

1. the consultation paper clarifies the approach only for Central Bank facilities (i.e. assets are considered to be encumbered/unencumbered based on the amount used and allocated on a pro-rate basis) while does not provide guidance for transactions like repo/reverse repo in GC Pooling or in case of retained Covered Bond issues.
2. Treatment of Covered Bond retained issues : the consultation paper (Annex 2, p.6) proposes to consider as unencumbered the amount of the covered bond pool that is backing those securities. This netting approach would not be consistent with some legal framework for covered bonds (e.g. Austrian one) that does not allow the issuer to reduce the amount of assets in the pools if it is retaining some of the issuance. In case of a netting approach than it should be defined by EBA the method to identify which assets are encumbered and which on are unencumbered). Should also be clarified for Collateral received (Template AE – Collateral) which kind of approach should be followed to identify the collateral received when backed by a pool (like GC Pooling).

adopted and its consequences on the interpretation of the framework, they could differ even in a substantial way.

The first difference to be taken into consideration is ownership versus full availability of the assets. The second difference to be taken into account is ownership spot versus forward.

Generally speaking an ideal approach which could prove to be fruitful should consider the encumbrance with relationship to the concept of ownership.

After a careful assessment of different typologies of operations based on the above mentioned criteria, the sole approach of encumbrance that seems to be efficiently applicable is the one based on a legal definition of ownership of the assets that may be encumbered to grant or fulfill contractual commitments by their owner, to be further enhanced through cross-border legal harmonization, in order to assure data comparability and level playing field implementation. The legal view seems to be also more aligned with the recovery/resolution perspective.

Under these premises, any prior effort should be made to harmonize at EU level the relevant laws/standards at least for the most relevant product types (e.g. securitizations /self-securitizations/covered bonds/own issued covered bonds - and respective management of related buybacks - securities lending/borrowing, repo/reverse repos etc.). At least for G-SIFIS we would recommend to adopt a common legal framework based on international laws.

The asset encumbrance definition we are proposing is therefore the following: “the portion of assets that, irrespective of their in/off-balance accounting representation, at reporting date:

- 1) **are legally owned by the Institution:** assets that could be sold by the Bank;
- 2) **are re-used** as guarantee/pledge towards all the effective/potential in/off-balance obligations

The asset encumbrance should be assessed also considering, within the reporting flow, the length of the encumbrance period both considering going-concern and crisis management upon pre-defined/harmonized scenarios”. This would mean that, in case of contracts which imply the temporary transfer of the legal ownership of the assets with a forward mandatory re-purchase of them, at reporting date (t0) the mapping of the transaction should include both the evidences of the legal ownership:

1. Spot – no ownership of the asset, thus exclusion of it from the encumbrance calculation process;
2. Forward – ownership of the asset, thus inclusion of it in the encumbrance calculation process.

A breakdown of assets owned by the Bank (per contract type, counterparty type, and regulatory portfolio the asset belongs to) could be disclosed within the explanatory notes of the Balance Sheet, indicating both notional and market values. Such assets could be further divided between unencumbered and encumbered (being re-used by the legal owner in other contracts - not just for secured funding purposed).

In addition, from a bail-in and RRP perspective, the explanatory notes of the Balance Sheet could further disclose a breakdown of interest rate bearing funding sources divided by secured and unsecured and per contract type, counterparty type, and regulatory portfolio they belong to.

Finally, it should be pointed out that, as a possible cons of the “legal approach” proposed by UCG answering to EBA CP, a reconciliation need with the Accounting view (based on IFRS) will arise, as under a regulatory perspective - supervisory notifications will be due according to EBA requirements. While identifying IT solution aimed at implementing the possible new reporting flow, the effort to set up consistent data gathering processes and related consistency checks should be duly taken into account.

Why the “accounting/regulatory principles” representation could be misleading?

Even though the EBA paper seems to suggest – when disciplining the approach towards securitizations – to consider the accounting view, as the derecognition of assets underlying the securitization notes is explicitly mentioned, we do not believe that the way of accounting such a transaction may lead to a

correct/direct understanding of the assets that could be considered as unencumbered for the reasons that follow (e.g. RMBS).

Where IAS principles apply, all mortgages underlying RMBS are accounted among originating Bank's assets once the SPV is consolidated, whereas RMBS notes retained/repurchased are not represented (as a conventional rule on the liability side a "phantom liability" arises substantially equal to the total of mortgages deducted by the amount of the retained/repurchased notes).

Considering that only the retained/repurchased notes of which the Bank is owner (not the mortgages, which have been legally acquired by the vehicle issuing the notes) could be pledged for Central Bank re-financing activities, it is not advisable to consider as unencumbered the portion of underlying assets which is not ideally absorbed by the related securitization notes used as pledge for Central Bank refinancing activities. Although it cannot be retrieved directly from the Balance Sheet because of accounting conventions, the real encumbrance can be worked out only on the notes that their owner actually pledged and used to obtain Central Bank refinancing, since the ownership of the relevant underlying assets has been transferred to the SPV issuing the notes.

More generally, taking into consideration the way the accounting/regulatory principles recognize other contract types e.g. secured lending activities with cash or non-cash collateral and the repo activity, it is crucial that the explanatory notes to the Financial Statement should be disciplined according to the concept of ownership vis-à-vis availability of an asset.

Finally, we take the opportunity to point out that the encumbrance proposed by EBA, referring to a "pro-rata approach" for certain types of products, is not aligned with the BCBS/QIS progressive absorption approach (from lower quality assets to better one). In order to assure that the approach is aligned with what banks do in reality, we would propose the adoption of an algorithm that optimizes the asset allocation.

Why the "economic view" representation could be misleading?

Adoption of an "economic view approach" may introduce "subjective local interpretations", not verifiable ex-post, that may lead to an unlevel playing field, making it uneasy to compare data across financial services industry players, especially in case an harmonized international legal framework, at least for G-SIFIS, is defined.

In addition, as already mentioned, legal view seem more aligned with the recovery/resolution perspective.

Furthermore, within the consultative paper it is stated that the "encumbrance" cannot merely rely on "legal definitions", but should consider also "economic principles", which should be, however, closely linked to contractual conditions.

The opportunity to consider, as proposed, an "economic principle view", potentially in contrast with the legal definitions, but in line with contractual conditions, seems to represent an intrinsic contradiction. Contract conditions should be always compliant with the legal framework. This would imply that the focus should be better put on the legal aspects.

Having in mind the approach proposed for securitizations, it should be pointed out that the legal perspective would be in contrast with the economic view. As already said, underlying assets do not legally belong anymore to the originating bank but to the SPV.

Final considerations: one definition to be coherently adopted also considering the reporting objective

The adoption of the legal view for asset encumbrance definition should be duly managed according to the objective of the reporting towards Regulators. More specifically it should be distinguished between:

1. FINREP/COREP are aimed at representing an AS-IS situation (the legal approach could be applied without exceptions);

2. Basel 3 indicators are aimed, on the other hand, at introducing a minimum requirement which is based on wide stress/idiosyncratic risk scenario. Different weights are applied to Bank's assets/liabilities following the scenario's assumptions taking into account their "economic" perspective (not necessarily aligned with the legal/contractual approach).

For example, with reference to NSFR (BCBS – QIS approach) a preferential treatment is currently assigned to mortgages underlying RMBS, which are considered as unencumbered in case RMBS are not used for e.g. Central Bank refinancing operations.

In this case, adopting tout court the legal definition, mortgages should be considered as encumbered and the preferential treatment consequently lost, due to the fact that for Basle 3 purposes a look-through approach with respect to the SPV has been adopted, irrespectively of any consideration about the legal ownership of the relevant assets.

Remark: as a consequence, careful steps should be taken to preserve the above mentioned preferential treatment, possibly assigning to the retained/bought back notes the same coefficients as those relevant to the underlying assets.

With reference to LCR (BCBS – QIS approach) a particular attention has to be given to the difference between the concept of asset encumbrance based on assets legally owned and that of Liquidity Buffer, which is focused on assets available for the next 30 calendar days (irrespective of their legal ownership).

Some examples deriving from the “legal treatment view”

Asset encumbrance definition should follow the steps that follow:

- **Test 1 (T1):** Define a list of the assets that the bank is legally owning at reporting date;
- **Test 2 (T2):** Assess if the assets are re-used by the bank. If they are re-used they should be considered as encumbered;
- **Test 3 (T3):** Identify for each asset the encumbrance period;

As follows some case examples focused on **Tests above**:

- A. **security lending against cash collateral:** at the reporting date the bank is legally owning the asset lent (T1). Securities lent are re-used, they are encumbered (T2). The securities are encumbered spot but unencumbered at maturity of the securities lending contract (T3).

Remark: cash received represents a secured funding source for the securities lender, and the possibility to include it among its owned assets depends on the legal framework underlying the contract

- B. **repos:** same as above;
- C. **owned assets pledged in exchange for cash (supranational funding operations and covered bonds as long as they are not transferred to a SPV):** same as above;
- D. **Owned assets lent without collateralization (not collateralized security lending):** same as above
- E. **Operations of funding or security borrowing against collateralization of borrowed assets** (repo and security lending transactions with a not owned underlying asset): no assets are owned (T1) and therefore no impact on asset encumbrance reporting
- F. **Securitizations:** the originating Bank is owning just the bought-back/retained notes, any credit towards the SPV and the cash deriving from the portfolio purchase price (less the price of the

notes retained/repurchased). No other assets could be included as at reporting date no other assets are legally owned /can be subject to creditor's legal actions (T1), in case they are not pledged e.g. for central bank refinancing they could be considered among unencumbered assets (T2). In case they are re-used please refer to point A, and (T3) could be performed.

- G. **Covered Bonds (with assets transferred to the SPV):** the originating Bank is owning just the bought-back/retained notes and the credit towards the SPV less the price of the notes placed on the market). No other assets could be included as at reporting date no other assets are legally owned /can be subject to creditor's legal actions (T1), in case they are not pledged e.g. for central bank refinancing they could be considered among unencumbered assets (T2). In case they are re-used please refer to point A, and (T3) could be performed.

Question 2: Do you agree with the decision to follow the level of application as set out for prudential requirements? If not, what other level of application would be appropriate?

Yes we agree to follow the level of application as set out for prudential requirements.

The remittance dates proposed:

- Quarterly reporting: 12 May; 11 August, 11 November and 11 February
- Semi-annual reporting: 11 August and 11 February;
- Annual reporting: 11 February

are not aligned with current financial statement approvals.

In addition, clarification is needed on reporting requirements on a consolidated basis. Might it be possible that there will be a waiver for e.g. Group sub-holdings and other subsidiaries which are part of the Banking Group, i.e. that only the Group Parent Company will report on an individual level and also, beside others already include all sub-holdings/subsidiaries, in the consolidated report? In case the reporting requirement applies also at sub-holding level, has the Sub-holding to report it on a consolidated level including all the subsidiaries (also the one that are below the 30bn thresholds) or is it sufficient to meet the reporting requirement on a solo level ?

The idea behind is to try to reduce the burden of regulatory reports within banking cross-border Groups. This Regulation should, inter alia, contain the prudential requirements for credit institutions and investment firms that relate strictly to the functioning of banking and financial services markets and are meant to ensure the financial stability of the operators on these markets as well as a high level of protection of investors and depositors. This Regulation aims at contributing in a determining manner to the smooth functioning of the internal market and should, consequently, be based on the provisions of Article 114 TFEU, as interpreted in accordance with the consistent case-law of the Court of Justice of the European Union.

Question 3: Do you believe the chosen definition of asset encumbrance is appropriate? If not, would you prefer a measure that is based solely on on-balance sheet activities (collateral received and re-used, for instance from derivatives transactions would not be included) or a liability?

Please refer to the answer to the Question 1. The encumbrance ratio should be defined accordingly. However, we think that also off-balance sheet assets should be included as they do have quite an impact on the ratio.

Question 4: Do you agree with the thresholds of respectively € 30 bn in total assets or material asset encumbrance as defined as 5% of on- and off- balance sheet asset encumbrance? If not, why are the

levels not appropriate and what would be an appropriate level? Should additional proportionality criteria be introduced for the smallest institutions?

It depends on the final encumbrance definition to be adopted. In addition, the question is if those thresholds imply, that on a consolidated basis only those institutions are included which already have to report on an individual basis (i.e. are above the thresholds)? Please also refer to answer to question 2 proposing a waiver.

Question 5: Under which circumstances might unencumbered assets of the types of loans on demand, equity instruments, debt securities and loans and advances other than loans on demand not be available for encumbrance?

Depending on the beneficiary of the assets encumbrance, there are various criteria that assets need to fulfill in order to be encumbered, e.g. rating of the debtor, type of asset, currency, legal framework. In addition, there may also be criteria linked to the pool of encumbered assets, e.g. concentration limits on client risk or client industry.

Finally, please refer to the answer to the Question 1 proposing an encumbrance definition.

Question 6: What additional sources of material asset encumbrance beyond the ones listed in rows 20 to 110 and 130 to 150 in template AE-Sources do you see?

The template should be revised according to the asset encumbrance definition proposed.

With reference to contingent encumbrance there are also other causes that could be taken into consideration already required e.g. within Basel 3 ratios calculation (overcollateralization/ haircut/ margin requirement increases):

- additional collateral required when the Bank is downgraded and does not have adequate rating any more (e.g. on funding received from institutions like the EIB; other example, on derivatives in which the Bank is “swap counterparty” towards an SPV);
- the additional collateral required by the loss of the fair value of the collateralized contracts (e.g. derivatives with CSA agreements).
- Short sales” are missing. They should be treated like security lending without cash collateral.
- additionally deposits guarantee scheme pledges are not mentioned in lines above (in Poland banks are obliged to maintain pledges for Banking Guarantee Fund – even if BGF is not used).

Question 7: Do you believe central bank repo eligibility criteria is an appropriate marketability criteria or should other criteria, such as risk weights, be used? If other criteria should be used, what could be the alternative?

YES, since it would be also aligned to final LCR regulation that includes also Central Bank standby credit facilities in the High Quality Liquid Assets.

Clarification on how to identify central bank eligible loans: while for central bank eligible securities there is a clear method and the securities can be identified by the ISIN, it should be instead clarified how to identify central bank eligible credit claims. Since it is not feasible to assess eligibility criteria for single loans, it should be defined an approach/criteria. The most strict approach could be to consider as central bank eligible only the credit claims already pledged to the Central Bank.

Other criteria like low bid-ask spread, low volatility, minimum turnover ratio are much harder to measure and give reason for misinterpretation. Central bank repo eligibility on the other hand is a “hard” fact. So we agree with this suggestion.

As a final consideration, considering that FINREP/COREP objectives may diverge from the Basel 3 stressed ratios, the beneficial treatment applied to some asset classes (e.g. LCR) should not be negatively affected by the “marketability definition” that may derive from this EBA consultation.

Question 8: Do you believe the chosen scenarios are appropriately defined? What alternative definitions would you apply?

Please also refer to question 6.

The consultation paper says a three notches downgrade scenario was not included because is already included in the LCR template. But in the LCR final text (in CRR) there is no explicit reference to a 3 notches downgrade scenario and Art. 411 refers to a scenario with a “material deterioration of the credit quality” of the institution, leaving to local competent authority the task to assess the materiality and define the potential outflow. No draft implementing technical standards (DTS) are expected to be developed by EBA for this LCR requirement. Given so there will be no consistent reporting in EU and the local regulator will evaluate materiality and follow different approaches in charging additional unexpected outflows in case of downgrade.

Loans in covered bond pools or pledged to the central bank are not marked to market, so a decrease in the fair value would not cause the need to place additional collateral, unless the loans do not meet any longer the eligibility criteria. The decrease in fair value would then only be relevant for securities pledged to central bank, in GCPooling or in the covered bond pool. In case if derivatives transactions since we have mainly cash collateral, there could be no impact.

The proposed scenarios will require some assumptions/simulations in the case of mortgage covered bond pool, where also the value of the collateral should be taken into consideration.

In addition, it should be pointed out that a decrease of 30% in the fair value of encumbered assets or decrease of 10% in significant currencies seems to be appropriate. Here only the threshold for “significant” currencies needs to be defined.

Finally, we take the opportunity to highlight that have noted the overlap with the stress testing performed under the liquidity coverage ratio and with the testing required under the Pillar 2 framework and firms’ recovery and resolution planning.

Question 9: Do the instruction provide a clear description of the reporting framework? If not, which parts should be clarified.

We believe that, as pointed out in the answer to Question 1, the first required step is to agree on a clear asset encumbrance definition. The reporting framework should be revised accordingly.

Nevertheless, the general framework does not show areas of improvement in terms of clarifications; the requested data seems to be essentially “balance sheet” compliant (as “carrying amount” and “fair value”). Further questions may arise when the IT interface will be defined.

Finally, we would welcome the opportunity to have a summary of questions and answers (FAQ) for the asset encumbrance, similar to the QIS studies for the LCR and NSFR.

Question 10: Do you identify any overlaps with the existing reporting framework, which could be mitigated?

FINREP templates n° 12 and 22 also contain information about the Collateral. It is kindly asked to confirm that such overlap will be mitigated.

In addition, asset encumbrance figures are required also for other reporting purposes like in NSFR and Recovery and Resolution Plans. In order to avoid non consistent representations, the definitions and rules to identify encumbered/unencumbered assets should be the same for all the different reports. The most efficient solution would be to concentrate all the information needed on asset encumbrance in this Asset Encumbrance Reporting and refer only to these figures for any other regulatory reporting.

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

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