Lyddon
CONSULTING SERVICES LTD

07939 132341
enquiries@lyddonconsulting.com
www.lyddonconsulting.com

Unicredit SpA: out of the frying pan?

The recapitalisation of Unicredit S.p.A.: an examination of the capital adequacy of Unicredit SpA in the light of (i) the accounting of its 13-for-5 rights issue; (ii) its level of provisioning for Bad and Doubtful Debts; and (iii) the accounting of its investments in its banking subsidiaries

Bob Lyddon **December 2017**
Director - Lyddon Consulting Services Limited

Executive Summary

This paper examines the first phase of the "recapitalisation" plan for Unicredit S.p.A. to get the bank out of the thoughts of banking regulators. The source of funding for this exercise was raised via a rights issue in February/March 2017 in an amount of €13.0 billion.

The destination of these funds was to cover provisions of €12.2 billion taken in the final quarter of 2016, broken down as €3.6 billion to increase write-downs on a portfolio of Non-performing loans ("NPLs") which were to be sold off (the FINO project), €4.5 billion to increase write-downs on the remaining portfolio of NPLs being retained (the PORTO project), and €4.1 billion of other provisions. In addition, Reserves reduced in 2016 by a further €2.1 billion, bringing them to (€2.5 billion), if that is not a non-sequitur.

The bank continues to skate on very thin ice:

- The European Central Bank is examining the FINO project to see if the sale price was artificially inflated to alleviate Unicredit from making a further write-down;
- Regulatory capital is made to appear adequate because Unicredit's Internal Risk-Based Approach to calculating its ratios permits it to shrink its assets by 58% before setting its capital against them.
- Unicredit's capital is being used twice: to support its own business and also that of its banking subsidiaries. Under Basel II the capital owned by Unicredit SpA in the latter should be backed out of the capital available to support Unicredit SpA's own business.

Unicredit SpA has a major capital deficit if Basel II is applied as commonly understood. In addition, a bank that has allowed 21.37% of its loans in Italy to become NPLs should not be allowed to run an Internal Risk-Based Approach to credit assessment at all. The Italian loan book is still held at a value that appears optimistic, for the same reasons that investors appear to have valued the FINO portfolio below the level of 12.96% of nominal which Unicredit must achieve in order not to take a further write-down.

The documentation around the rights issue was not particularly clear about all of this, especially in not disclosing that the €13 billion raised by the rights issue in Q1 2017 had already been used up – along with 2016 profit on operations - in provisions and charges that reduced Reserves from €10.3 billion at 31/12/15 to (€2.5 billion) at 31/12/16.

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Section 1 – quality of accounting, background to the rights issue and profile of Unicredit

Summary of Unicredit SpA regulatory capital position
The rights issue was launched, subscribed and paid in in Q1 2017; the provisions and charges disclosed in the Prospectus were taken in Q4 2016.

In between Unicredit was out of compliance with its regulatory capital ratios.

Even now, the compliance of the stock-exchange listed bank – Unicredit SpA - with regulatory capital ratios is contingent upon:

1. The acceptance that the bank's Internal Risk-Based Approach ("IRB") adequately assesses the credit risk on its performing loans, when the same methodology has allowed 21.37% of its total customer loans to become NPLs;
2. The final completion of the FINO project in its entirety and for a net sale price for the portfolio of at least 12.96% of nominal value, and its subsequent refinancing through the European System of Central Banks (the "Eurosystem");
3. The bank's ability to realise at least 43.43% of nominal value from the remaining NPL portfolio, the PORTO project having reduced the "carrying value" down to this level;
4. The continued agreement of regulators to allow Unicredit SpA to assess the capital needed to hold shares in its major banking subsidiaries in Germany, Austria and Central&Eastern Europe through the bank's IRB methodology, instead of deducting the investment 1-for-1 against Unicredit SpA's capital, as Basel II dictates;
5. An absence of significant NPL problems in the loan books of these foreign banking subsidiaries.

Quality of accounting
Important anomalies pertain to Unicredit's accounting.

The issue of how Unicredit SpA treats its investments in banking subsidiaries is dealt with more extensively below. In short Unicredit SpA does not deduct these investments back from its own capital in order to determine the capital available to support its own loans and other assets.

The description of the Q4 2016 provisions for NPLs in the Prospectus for the rights issue (p608) does not tally with nominal figures for NPLs in the Unicredit 2016 annual report (p33). The PORTO project was stated to be costing €4.5 billion in provisions and was supposed to reduce the carrying value of the NPLs - other than the FINO portfolio of NPLs - by 6%. Yet €4.5 billion is 6% of €75 billion, not the figure of €56 billion which is the largest nominal value for NPLs visible in the Unicredit 2016 annual report.

The development of the bank's Share Capital is both very difficult to follow through the source documents and also subject to one major inconsistency. The share capital is stated in the annual reports and Prospectus as being composed of Share Premium (line 170) and Share Capital (line 180). For example in the 2015 unconsolidated annual report line 170 is stated as €15.9 billion and line 180 is stated as €20.2 billion.

While assigning a par value to its shares in its accounts consistent with their aggregate par value being €20.2 billion, Unicredit repeatedly states in the rights issue documentation that they have no par value, and that they have a par value of €0.01. Both cannot be true, and whichever it is, it is inconsistent with lines 170 and 180 in its accounts.

In many countries it is illegal to issue shares with no par value: then Share Capital would always be zero in the accounts, and the company could issue an unlimited number of shares without altering its Share Capital. This would then lend an air of impermanence to the Share Capital, whereas Share Capital should be the prime source of long-term funding.

Indeed, under Basel III, regulators have required that the portion of bank capital held as redeemable or distributable items reduce, and the portion held as permanent items increase.

Background to the rights issue

The rights issue was positioned by Unicredit senior management as part of a Strategic Plan, and not one to fund expansion. The objectives of the plan were variously to recapitalise the bank, to improve the quality of its assets, to digitise the bank and to cut its costs.

That the rights issue closed and was declared a success is not to say that the "recapitalisation" has been successful: the rights issue only represents adequate new funding if the other parts of senior management's Strategic Plan are delivered and if many assumptions turn out to be correct.

The prospectus for the issue contains a long list of risks and of pending litigation. The prospectus is the "Registration Document prepared pursuant to the regulation adopted by CONSOB through resolution 11971 on 14 May 1999, as later amended and supplemented and Article 4 of Regulation (EC) No 809/2004 of the European Commission of 29 April 2004 containing the application methods of Directive 2003/71/EC, as later amended and supplemented" and is referred to in this paper as the "Prospectus".

A further document was filed with CONSOB on 15th February 2017, during the issue process, entitled as a Supplement to the Prospectus. It contained numerous corrections of the data in the Prospectus. This document is referred to in this paper as the "Supplement".

Despite this extensive documentation, the nub of the whole plan is the NPLs:

- These stood at €55.5 billion in nominal value at 31/12/15 in the unconsolidated annual report (p32)
- They had been written down to a "carrying value" of €26.4 billion at that date
- This figure was then added to the €188.8 billion of Performing Loans to produce the total figure for loans to customers of €215.2 billion at 31/12/15
- 22.61% of Unicredit's loans to customers were on NPL status at that time
- At the same date Unicredit's capital and reserves stood at €46.5 billion
- The carrying value can be considered generous considering the slow Italian legal process for making recoveries on NPLs, the time elapsed since many of the NPLs had made a payment at all, and the industry's recent experience of making recoveries
- It is important to note as well that Unicredit subjects the carrying value to its Internal Risk-Based Approach to credit assessment to determine the capital to be held against its NPLs i.e. to determine the risk of the bank not realising the carrying value, which at 31/12/15 stood at 47.51% of nominal value (100% less write-downs of 52.49%)

In effect the rights issue funded further large write-downs in "carrying value" on a portfolio of NPLs to be sold (FINO) and on the residual portfolio of NPLs to be retained (PORTO).

Stage of completion of the FINO project

It is important to note that at the time of writing the FINO project has not yet been finally completed. The Prospectus represented that contracts had been signed with third-parties and it inferred – but did not explicitly state – that Unicredit was holding the FINO portfolio, after the write-down in Q4 2016, at 12.96% of its nominal value.

Common to transactions of this type, the selling bank transfers the subject NPLs to a special purpose company, in which there is a very thin layer of equity and then modest layers of junior and senior mezzanine debt. The main supplier of funds to the special purpose company is the same bank that sold the portfolio of NPLs to it. As consideration for the sale of the portfolio, the special purpose company allocates to the bank the most senior liability of the special purpose company, namely an issue of medium-term Floating Rate Notes ("FRNs" or simply "notes").

The payments on the Senior debt FRNs are guaranteed by the Republic of Italy.

There would typically be four levels of capitalisation in the special purpose company, where the third-parties would be hedge funds and Atlante II is a special Italian fund established by the Italian banks to support these types of transaction:

Description	Type of security	Typical case	Fino
Senior debt	Class A FRNs	Selling bank	Unicredit
Senior mezzanine	Class B FRNs	Third-parties	Unicredit 49% and third-parties 51%
Junior mezzanine	Class C FRNs	Atlante II fund	Unicredit 49% and third-parties 51%
Equity	Shares	Atlante II fund	Unicredit 49% and third-parties 51%

FINO differs significantly from the typical case because Unicredit is a part owner of the special purpose company, and Atlante II is not involved.

Holding a minority stake of 49% in the special purpose company is enough for Unicredit to take the entire FINO portfolio out if its customer loans in line 70 in its accounts. Its shareholding in the special purpose company would be added to line 100 "Equity investments". As the Equity layer is small, Unicredit's investment of equity will be small.

The result even at this stage is has significant benefits for Unicredit:

- Unicredit can hold all the notes in line 20 "Financial assets held for trading" instead of in line 70
- It is entitled to hold 0% capital against the Class A notes because of the Italian government's sovereign guarantee
- This asset counts as a "High-quality liquid asset" for the purposes of compliance with the two ratios of liquidity in Basel III:
    - Liquidity Coverage Ratio
    - Net Stable Funding Ratio

But FINO will not be a success until all of the Class A notes relating to the whole FINO portfolio are on the European Central Bank list of eligible collateral and re-financed by the National Central Banks in the Eurosystem. The aggregate of Class A notes should be over €2.1 billion if they are issued in the same proportion (12.26%) to the nominal value of NPLs backing them as the Class A notes do compared to the NPLs of €5.3 billion backing the first transaction that has been announced.

The Class B and Class C notes are then the make-weight that bring the total of notes issued to Unicredit to the same value to which it wrote the FINO portfolio down in its 2016 accounts: €2.2 billion or 12.96% of nominal.

The current stage of FINO can be deduced from a story on Bloombergs on 30/10/17, and from a press release issued by Unicredit on 23/11/17.

It was firstly revealed that there is not just one FINO-related securitisation vehicle company but more. The press release announced that the rating agency DBRS had assigned a BBB rating to the Class A notes issued by "Fino 1 Securitisation s.r.l." and that these were backed with €5.3 billion of NPLs. Unicredit was thereby signaling that there could be "Fino 2 Securitisation s.r.l." and possibly "Fino 3 Securitisation s.r.l." and so on, until all of the €17 billion nominal of NPLs earmarked to the FINO project have gone through the process.

Less than one third of the FINO portfolio has thus reached the stage of being publicly rated, and even then only at BBB for the Class A notes by one agency, and at A2 by Moody's.

The Class A notes need to be publicly rated in order to be eligible for ECB finance and by two of the four main agencies at the level equivalent to Single A in the S&P system, in order for the notes to be admitted to the European Central Bank's list of eligible collateral.

With a rating of A2 from Moody's, Unicredit needs either S&P themselves or Fitch to assign a rating equivalent to Single A or better, and then the Class A notes can be admitted to the ECB list of eligible collateral (assuming that the ECB can get over the issue of the valuation of the Non-Performing Loans themselves - see below for more on that).

Until then Unicredit itself is the sole owner of the Class A notes, issued to them in exchange for selling the portfolio of NPLs that sits behind the issue. In fact, because Unicredit is a 49% shareholder in "Fino 1 Securitisation s.r.l.", it will also be owning:

1. 49% of the Class B notes of €29.64 million = €14.52 million;
2. 49% of the Class C notes of €40 million = €19.6 million;
3. €684.1 million of notes in all.

The NPLs behind the "Fino 1 Securitisation s.r.l." structure amount to around €5.3 billion in nominal value, so the total of Class A, Class B and Class C notes issued against this portfolio - at €720 million - equate to 13.5% of the nominal, and the portion of the notes that Unicredit owns - €684.1 million - is 12.90% of the nominal.

Unicredit wrote the value of the entire FINO portfolio down to 12.96% of nominal in its books in late 2016, so we can posit that Unicredit sold the respective portion of the FINO NPLs that sits behind "Fino 1 Securitisation s.r.l." at exactly the value to which it had written them down. Unicredit thus avoided the embarrassment of putting a further provision through line 130.a in its P&L account, over and above the provision of €3.6 billion for writing down the whole FINO portfolio that was disclosed in the Prospectus for the rights issue.

Unicredit still needs to complete all the following for the FINO project to be a success:

1. Obtain a Single-A from S&P or Fitch on the Class A notes from "Fino 1 Securitisation s.r.l.";
2. Procure that the Class A notes from "Fino 1 Securitisation s.r.l." are admitted to the ECB list of eligible collateral;
3. Borrow from Eurosystem members against Class A notes from "Fino 1 Securitisation s.r.l.";
4. Establish "Fino 2 Securitisation s.r.l.", "Fino 3 Securitisation s.r.l." and so on until all the €17 billion nominal have been put through the process;
5. Obtain two Single-A or equivalent ratings on all Class A notes;
6. Procure that all Class A notes are admitted to the ECB list of eligible collateral;
7. Borrow against all Class A notes.

Obstacles to the full and successful completion of FINO

There are three significant obstacles to full completion:

1. ECB enquiry into how the sale price into the special purpose company has been arrived at;
2. Quality of the NPLs that will be put behind "Fino 2 Securitisation s.r.l.", "Fino 3 Securitisation s.r.l." and so on;
3. Ability to get the right ratings on the Class A notes.

The three obstacles are interrelated.

ECB enquiry into how the sale price into the special purpose company

Bloombergs reported that the European Central Bank is currently examining the transaction, on the point of whether “the already low price at which the loans were sold…was inflated by fees the bank is paying to the buyers to manage the loans. If Unicredit is forced to strip out those fees and re-price the deal, more losses could follow”.

What this infers is that the co-investors, who own 51% of the securitisation vehicle company, did not value the FINO portfolio as a whole at 12.96% of nominal but lower. In order to bridge the gap – and let’s posit that the valuation was 8% of nominal - Unicredit appears to have been willing to pay some sort of inducement fee separately, to induce the securitisation vehicle company to issue it with notes to the value of 12.96% of the NPLs.

Unicredit would then have had to pay out 4.96% of nominal as a commission to the securitisation vehicle company through its P&L account, whereas a shortfall in the sale price would have had to be taken as a further write-down through the P&L account in line 130 – as were the provisions in Q4 2016.

An inducement fee could be put through under line 50: FINO would then be completed without further write-downs in line 130. The 4.96% fee on €17.0 billion - despite being €843 million and causing a tripling or more of line 50 year-on-year – would get lost in the figure in line 60 for “Net fees and commissions” of over €3 billion.

Here is the relevant extract from the unconsolidated 2016 P&L account:

Income Statement (€)

ITEMS	YEAR 2016	YEAR 2015
10. Interest income and similar revenues	6,227,564,569	7,287,626,938
20. Interest expenses and similar charges	(2,534,028,520)	(3,252,384,982)
30. Net interest margin	**3,693,536,049**	**4,035,241,956**
40. Fees and commissions income	4,082,085,681	4,205,454,685
50. Fees and commissions expense	(386,232,325)	(368,170,617)
60. Net fees and commissions	**3,695,853,356**	**3,837,284,068**
70. Dividend income and similar revenue	1,172,564,470	1,475,529,410
80. Gains (Losses) on financial assets and liabilities held for trading	140,661,348	194,509,003
90. Fair value adjustments in hedge accounting	(2,746,530)	7,386,379
100. Gains (Losses) on disposal and repurchase of:	308,540,278	204,918,442
a) loans	*4,155,093*	*(25,867,903)*
b) available-for-sale financial assets	*294,892,812*	*246,497,724*
c) held-to-maturity investments	-	*(2)*
d) financial liabilities	*9,492,373*	*(15,711,377)*
110. Gains (Losses) on financial assets/liabilities at fair value through profit or loss	(82,520,090)	13,161,224
120. Operating income	**8,925,888,881**	**9,768,030,482**
130. Net losses/recoveries on impairment:	(10,933,079,438)	(2,667,654,568)
a) loans	*(9,996,114,908)*	*(2,593,265,051)*
b) available-for-sale financial assets	*(684,693,146)*	*(41,124,605)*
c) held-to-maturity investments	-	-
d) other financial assets	*(252,271,384)*	*(33,264,912)*
140. Net profit from financial activities	**(2,007,190,557)**	**7,100,375,914**

If this is what has occurred with the first transaction, Unicredit will be holding notes with a face value of 12.90% of the nominal value of the "Fino 1 Securitisation s.r.l." portfolio or €684.1 million, and the co-investor is holding 51% of the Class B and Class C notes, making up total financing of "Fino 1 Securitisation s.r.l." of €719.64 million, or 13.58% of the nominal value of the NPLs.

However, if the underlying valuation of the NPLs is 8% of nominal but the notes are for 13.58% of nominal, the value of the notes has been artificially inflated: the assets behind the notes do not support that valuation. If that is the case then Unicredit is:

- over-valuing the notes in its own books;
- over-stating its compliance with Basel III Liquidity Coverage Ratio and Net Stable Funding Ratio.

In those circumstances the ECB will not want to be forced into a position of valuing the Class A notes at near to par as collateral for loans by Eurosystem members to Unicredit. If it does put the Class A notes onto its list of eligible collateral, the Eurosystem members will then be obliged to advance funds against them at face value less a very small haircut.

Eurosystem members would be compelled to advance funds to Unicredit of say €649 million (Class A notes' face value less haircut) against a portfolio of NPLs of nominal €5.3 billion, that the co-investors in the securitisation vehicle company had valued at 8% of €5.3 billion or €424 million. The loans drawn from the Eurosystem by Unicredit would then exceed the valuation of the underlying assets by €225 million (€649 million minus €424 million).

Quality of the NPLs that will be put behind "Fino 2 Securitisation s.r.l.", "Fino 3 Securitisation s.r.l." and so on
Another issue is what will be the quality of the NPLs behind "Fino 2 Securitisation s.r.l." and possibly "Fino 3 Securitisation s.r.l." and so on, compared to the ones behind the first issue.

Surely it is in the nature of things, to use a cricketing analogy, to send the best batsmen in first, or at least the most solid ones if not the most exciting. If Unicredit has done this and the best batsmen have been returned to the pavilion by DBRS notching up no more than a BBB with the scorers, it does not bode well for the middle order - "Fino 2 Securitisation s.r.l." - or the tailenders - "Fino 3 Securitisation s.r.l.".

The rating agencies will be concerned with this issue and it will then come to light whether the quality of NPLs is consistent behind all of the securitisations, or better behind some than others.

Ability to get the right ratings on the Class A notes
The rating agencies will be sensitive to the outcome of the ECB's enquiry, as they will be to the quality of NPLs behind each issue.

The judgement of the rating agencies is critical to the Class A notes being admitted to the ECB list of eligible collateral.

The ECB and the Eurosystem members (apart from the Banca d'Italia) will be hoping that the right ratings are not forthcoming: the ECB to spare themselves the embarrassment of deciding whether to overlook the price at which the NPLs were sold by Unicredit and what payments supported that price, and the other Eurosystem members so they do not have to refinance the FINO notes.

The FINO NPLs were taken from the very lowest category in Unicredit's NPLs - having travelled down from "Past due" to "Non-Performing and Past Due" to "Unlikely to Pay" and then to "Bad Exposures" (= highly likely not to pay).

All the way along Unicredit's provisioning of the loans was inadequate, as the documentation behind the write-down to 12.96% of nominal in Q4 2016 admitted.

If it turns out that the write-down was materially inadequate, there will arise the question of the veracity of the Prospectus and the Supplement for the rights issue.

This is the worst possible scenario for Unicredit, if it is indeed the case that the FINO NPLs could not be transferred off its books for an arm's-length price of 12.96% of nominal or better. The size of the subsidy that was paid could have been handled in several ways – such as an announcement of a Material Adverse Change in the value of the FINO portfolio. If the adjustment was indeed material, and if it has been disguised as a "Fee and commission expense", the question will arise as to whether Unicredit's handling of the matter was done in good faith towards its shareholders.

Unicredit profile
Unicredit is an international bank with major operations in Germany and Austria as well as Italy, and significant local operations in many other Central and Eastern European countries. It is also a Global SIFI: a "global systemically-important financial institution", Italy's only one. For that reason it should hold 1-2½% more capital against its assets than a non-SIFI, so that it can under no circumstances fail.

Unicredit consistently passed its European Banking Authority stress tests but was subject to a number of comments from the supervisors regarding its risk profile, thin capital buffers and weak profitability. These were contained in the Supervisory Review and Evaluation Process ("SREP"), are summarised on page 2 of the Prospectus and gone into in further detail on page 232 of the Prospectus.

The rights issue was critical to keeping the Unicredit show on the road and, while this may have been obvious to the bank itself and to financial regulators, these were not quite the terms upon which the issue was put to investors in the Prospectus. The Supplement is more sanguine in a number of respects.

Section 2 – composition of Unicredit capital and equity, and the rights issue

Rights issue
Unicredit launched its rights issue while stating that it was not obliged by regulatory authorities to increase its capital. This was literally true but arguably untrue: the Prospectus stated that Unicredit's regulatory capital would fall below the required levels between the date at which it took major provisions in Q4 2016 and when the rights issue was paid in, and indeed the degree of shortfall on one of the measures of capital had to be revised upwards in the Supplement.

The statement is literally true if one accepts that the provisions were only taken because the rights issue was planned, i.e. that the two actions were one operation.

It is arguably untrue, however, if one takes the view that the provisions were needed because of the status of Unicredit's business, whether the rights issue was planned or not.

Had the rights issue not gone ahead for whatever reason, regulatory authorities might well have obliged Unicredit to increase its capital, albeit that such an intervention would have been unrealistic by that stage – because a failed rights issue would have proved that Unicredit could not increase its capital from the investor market.

Surely the most likely explanation is that regulatory authorities had made it known to Unicredit that it needed to act and that they forbore on imposing an obligation to act because Unicredit made them aware of their Strategic Plan to act.

The rights issue – which was paid in by 3rd March - increased Unicredit's shares-in-issue by a factor of 260%, it being a 13-for-5 issue of rights, with a maximum of 1,606,876,817 new shares issued, for an aggregate amount of up to €16,068,768.17 in share capital (€0.01 per share) and up to €12,983,564,681.36 in share premium (€8.08 per share). These terms were announced in the press release of 1st February 2017.

Definitions used in composition of Unicredit equity
We have attempted, as best we can, to track Unicredit's capital and its other own resources from the 2015 annual report, through the Prospectus, the Supplement, the 2016 annual report (issued after the rights issue had been concluded and paid in), and to the situation after the pay-in of the rights issue.

We have used definitions that differ from those in the Prospectus, Press Releases and 2015 Unicredit S.p.A. Annual Report so as to counteract confusion that may be caused where "capital" is referred to as just meaning Share Capital, or as Share Capital plus Share Premium. We have accepted the definition of "share capital" as being exactly what it says – the Share Capital under line 180.

"Balance-sheet capital" is Share Capital plus Share Premium (line 170).

"Balance-sheet equity" is the entire amount of **capital** in the balance sheet that is owned by Unicredit S.p.A.'s shareholders and is not owed to any third party.

There are then Provisions that are not owed to any third party, and these occupy lines 110 and 120. These can be counted into the "Total of own resources": the entire amount of **funding** in the balance sheet that is owned by Unicredit S.p.A.'s shareholders and is not owed to any third party.

The published accounts and the Prospectus do not give all the figures needed for a complete comparison: in particular the Prospectus does not give unconsolidated figures for the Provisions in lines 110 and 120 as at 30/9/16.

Equally there is the issue of how to treat the amounts owned by parties who are minority stakeholders in companies in which Unicredit has a controlling interest (these amounts are known as "Minority Interests"). There are no such Minority Interests at the Unicredit SpA level, only at the group level. To deal with that issue we have concentrated on using the unconsolidated figures.

Defined terms used in this section and their meaning are thus as follows, linked back to the line numbers in the Unicredit SpA unconsolidated annual reports:

Term	Meaning	Line numbers
Balance-sheet capital	Share Capital + Issue Premiums	180 + 170
Reserves	The total of all the different types of reserve and the accumulated Profit&Loss Account	130 + 150 + 160 + 190 + 200
Balance-sheet equity	Balance-sheet capital plus Reserves	180 + 170 + 130 + 150 + 160 + 190 + 200
Provisions	On-balance sheet provisions	110 + 120
Total own resources	Balance-sheet equity plus Provisions	180 + 170 + 130 + 150 + 160 + 190 + 200 + 110 + 120

Composition of Unicredit SpA total of own resources before the rights issue

These are the relevant figures from the 2015 unconsolidated annual report:

100.Other liabilities	7,373,932,982	9,043,865,479
110. Provision for employee severance pay	1,028,374,419	1,059,051,641
120. Provisions for risks and charges	2,601,453,029	2,036,873,658
a) post retirement benefit obligations	*735,894,822*	*829,326,094*
b) other provisions	*1,865,558,207*	*1,207,547,564*
130. Revaluation reserves	1,092,027,055	1,001,109,067
150. Equity instruments	1,888,463,450	1,888,463,450
160. Reserves	8,753,683,190	9,323,078,472
170. Share premium	15,976,604,463	15,976,604,463
180. Share capital	20,257,667,512	19,905,773,742
190. Treasury shares (-)	(2,440,001)	(2,440,001)
200. Net profit (loss) for the year (+/-)	(1,441,448,594)	79,774,103
Total liabilities and Shareholders' Equity	**394,372,281,805**	**398,813,054,975**

And the same figures from the 2016 unconsolidated annual report:

100.Other liabilities	[illegible]	[illegible]
110. Provision for employee severance pay	1,019,712,831	1,028,374,419
120. Provisions for risks and charges	3,407,328,188	2,601,453,029
a) post retirement benefit obligations	*373,189,449*	*735,894,822*
b) other provisions	*3,034,138,739*	*1,865,558,207*
130. Revaluation reserves	716,180,292	1,092,027,055
150. Equity instruments	2,383,463,450	1,888,463,450
160. Reserves	5,828,365,938	8,753,683,190
170. Share premium	14,384,917,645	15,976,604,463
180. Share capital	20,846,893,437	20,257,667,512
190. Treasury shares (-)	(2,440,001)	(2,440,001)
200. Net profit (loss) for the year (+/-)	(11,460,132,615)	(1,441,448,594)
Total liabilities and Shareholders' Equity	**394,187,548,549**	**394,372,281,805**

The respective amounts deriving from the two tables are:

in € billions	31.12.15	31.12.16	Line numbers
Balance-sheet capital	36.2	35.2	180 + 170
Reserves	10.3	(2.5)	130 + 150 + 160 + 190 + 200
Balance-sheet equity	46.5	32.7	180 + 170 + 130 + 150 + 160 + 190 + 200
Provisions	3.6	4.4	110 + 120
Total own resources	50.1	37.1	180 + 170 + 130 + 150 + 160 + 190 + 200 + 110 + 120

The reduction of the Share Premium account by €1.4 billion – made in order to boost "Reserves of Profit" - appears arbitrary and questionable: surely the balance on the Share Premium account is a historical fact? It is the difference between the nominal value of shares when issued and the price per share paid by investors when they subscribed, times the number of shares issued at that point.

It would have been good to have comparative figures for 30/9/16 but the Prospectus is less helpful: it only gives pro-forma consolidated figures for 31/12/15 and 30/9/16 and not unconsolidated ones. We do not have figures for lines 110 and 120 on 30/9/16 on an unconsolidated basis and so cannot insert a column as at that date.

Composition of Unicredit Group total of own resources before the rights issue
Looking up to the group level, the figures below are drawn from the table on p659 of the Prospectus. Provisions are not shown in this table. The figures are in EUR millions and – it is important to point out again – are consolidated figures such that there are Minority Interests included:

Category	Sub-totals 31/12/15	Totals 31/12/15	Sub-totals 30/9/16	Totals 30/9/16
Share capital:				
(a) Ordinary shares	20,722		21,330	
(b) Other shares	9	20,731	9	21,339
Issue premiums		17,234		15,861
Balance-sheet capital		**37,965**		**37,200**
Reserves:				
(a) Of profits	9,964		13,339	
(b) other	5,636	15,600	5,647	18,986
Revaluation reserve		(4,002)		(5,037)
Equity instruments		1,888		1,888
Treasury shares		(11)		(7)
Net profit and loss		2,046		2,112
Reserves		**15,521**		**17,942**
Balance-sheet equity incl Minority Interests		**53,486**		**55,142**
Minority interests		(3,399)		(3,906)
Balance-sheet equity		**50,087**		**51,236**
Total reserves, P&L…		15,521		17,942
Total reserves, P&L…less Minority interests		12,122		14,036

The major changes in the consolidated figures between 31/12/2015 and 30/9/16 as per the Prospectus were:

- "Reserves of profits" rose by €3.1 billion,
- This was enabled:
  - firstly by an appropriation out of the 2015 net profit of €1.7 billion, the remainder of the 2015 net profit being paid out as a dividend
  - secondly by a reduction in the Share Premium account of €1.4 billion (which, as stated above, appears arbitrary)
- There was a profit for the 2016 year-to-date of €2.1 billion
- But there was a further reduction below zero of the Revaluation Reserve by €1.0 billion, meaning the net profit for the year-to-date was €1.1 billion

Unicredit's consolidated Balance-sheet capital was thus attested to be €37.2 billion as at 30/9/16, the latest full figures available at the date of publication of the Prospectus.

Adding in Reserves of €17.9 billion but without reversing out Minority Interests of €3.9 billion delivers a figure for the Balance-sheet equity as at 30/9/16 of €55.1 billion.

We can now perform the same calculations regarding the consolidated figures as we did for the unconsolidated ones above.

The 2015 consolidated annual report showed:

110. Provision for employee severance pay	1,134,776	1,180,206
120. Provisions for risks and charges	9,854,616	10,623,012
a) post retirement benefit obligations	*5,198,039*	*7,293,416*
b) other provisions	*4,656,577*	*3,329,596*
130. Insurance reserves	-	-
140. Revaluation reserves	(3,976,940)	(4,134,549)
150. Share capital repayable on demand	-	-
160. Equity instruments	1,888,463	1,888,463
170. Reserves	14,254,879	13,748,408
180. Share premium	15,976,604	15,976,604
190. Share capital	20,257,668	19,905,774
200. Treasury shares (-)	(8,171)	(2,795)
210. Minorities (+/-)	3,398,780	3,445,819
220. Net profit (loss) for the year (+/-)	1,694,240	2,007,828
Total liabilities and Shareholders' Equity	**860,433,375**	**844,217,390**

The 2016 consolidated annual report showed:

110. Provision for employee severance pay	1,125,758	1,132,457
120. Provisions for risks and charges	10,541,448	9,719,986
a) post-retirement benefit obligations	*5,241,807*	*5,107,031*
b) other provisions	*5,299,641*	*4,612,955*
130. Insurance reserves	-	-
140. Revaluation reserves	(4,039,304)	(3,976,940)
150. Share capital repayable on demand	-	-
160. Equity instruments	2,383,463	1,888,463
170. Reserves	17,553,781	14,254,879
180. Share premium	14,384,918	15,976,604
190. Share capital	20,846,893	20,257,668
200. Treasury shares (-)	(4,107)	(8,171)
210. Minorities (+/-)	3,852,752	3,398,780
220. Net profit (loss) for the year (+/-)	(11,790,094)	1,694,240
Total liabilities and Shareholders' Equity	**859,532,774**	**860,433,375**

The respective amounts deriving from the two consolidated tables are:

in € billions	31.12.15	31.12.16	Line numbers
Balance-sheet capital	36.2	35.2	180 + 170
Reserves	17.3	7.9	130 + 150 + 160 + 190 + 200
Balance-sheet equity	53.5	43.1	180 + 170 + 130 + 150 + 160 + 190 + 200
Provisions	11.0	11.7	110 + 120
Total own resources	64.5	54.8	180 + 170 + 130 + 150 + 160 + 190 + 200 + 110 + 120

Then we can contrast these figures with the unconsolidated ones:

	Unconsolidated		Consolidated	
in € billions	**31.12.15**	**31.12.16**	**31.12.15**	**31.12.16**
Balance-sheet capital	36.2	35.2	36.2	35.2
Reserves	10.3	(2.5)	17.3	7.9
Balance-sheet equity	46.5	32.7	53.5	43.1
Provisions	3.6	4.4	11.0	11.7
Total own resources	50.1	37.1	64.5	54.8

Finally we can contrast the consolidated figures in the 2015 and 2016 annual reports with the consolidated figures in the Prospectus for 31/12/15 and for 30/9/2016, again without the Provisions:

	Annual Reports		**Prospectus**	
in € billions	**31.12.15**	**31.12.16**	**31.12.15**	**30.9.16**
Balance-sheet capital	36.2	35.2	37.9	37.2
Reserves	17.3	7.9	15.5	17.9
Balance-sheet equity	53.5	43.1	53.4	55.1

What conclusions can we draw from these calculations?

Firstly that the consolidated Balance-sheet capital as at 31/12/15 is not the same figure in the annual report (€36.2 billion) as the Prospectus states for the same date (€37.9 billion).

Secondly that the figures for Reserves vary considerably. What were the consolidated Reserves actually as at the key dates?

The consolidated Reserves figures are much higher than the unconsolidated ones. If Reserves existed – positive or negative – in balance sheets other than that of Unicredit SpA, whose balance sheet were they on, and under what circumstances are they available to Unicredit SpA?

Is there not in itself something strange about having negative Reserves at all? Should not the assets they relate to rather be written down to their current value?

Perhaps the only hard-and-fast conclusions we can draw are these:

- Unicredit seems to feel it is at liberty to vary the amounts stated for Reserves in different documents for what should be a consistent figure e.g. consolidated Reserves as at 31.12.15;
- The presentation of the Reserves was inflated in the rights issue documents because the clearest statement of them was in the consolidated figure on p659 of the Prospectus, when these were not the Reserves at that date of the entity issuing the shares that the reader of the Prospectus was being invited to take up;
- The figures given for Reserves in the Prospectus were inflated by €12.2 billion given the actual position when the Prospectus was issued;
- A projected figure for Reserves as at 31/12/16 and either (i) as at the date of the Prospectus; or (ii) as at the date of the pay-in of the rights; or (iii) 31/3/17 could have been given for the benefit of clarity for the investors;
- A further reduction of Reserves of €2.1 billion occurred in between 30/9/16 and 31/12/16 which will have eluded investors: they are told explicitly that one-off write-downs of €12.2 billion would be taken in Q4 2016, not of €14.3 billion.

Anomalies in the accounting of Unicredit's share capital up to the Reverse Stock Split in January 2017

Unicredit's share capital was a moveable feast from 31/12/15 until the completion of the rights issue. The rights issue was agreed to in a Shareholders' Extraordinary General Meeting on 12th January 2017 and was then priced at €8.09 on 1st February 2017, a discount of around 33% to the then current market price.

The Shareholders' Extraordinary General Meeting that approved the rights issue at the same time authorised a Reverse Stock Split.

10 'old' ordinary shares would be exchanged for 1 'new' ordinary share with no par value, and 10 'old' savings shares would be exchanged for 1 'new' savings share with no par value. 7 ordinary shares and 6 savings shares, as well as fractions, were cancelled.

The company's number of shares in issue was another moveable feast between its 31/12/15 annual report, the Press Release of 17/1/17 about the Reverse Stock Split, and the Prospectus figures as at 30/1/17 (the so-called "Registration Date" of the rights issue).

Document	Date	Page	Share capital	Ordinary shares	Savings shares	Total shares
Annual report	31/12/15	58 (uncon) 83 (con)	€20,257,667,511.62	5,967,177,811	2,480,677	5,969,658,488
Press Release	17/01/17	n/a	€20,846,893,436.94	6,177,818,170	2,524,890	6,180,343,060
Prospectus	30/01/17	696	€20,846,893,436.94	6,177,818,177	252,489	6,178,070,666

The amount of Share Capital is stated consistently between the consolidated and unconsolidated 2015 annual reports.

But this differs from the amounts on p659 of the Prospectus – this gives consolidated Share Capital as at 31/12/15 (€20.7 billion) and at 30/9/16 (€21.3 billion), without backing out Minority Interests in Share Capital at 31/12/15.

It does back out Minority Interests for 30/9/16 – backing out €492 million from €21.3 billion to give €20.8 billion.

This figure does tie up with the Press Release of 17/1/17, the Prospectus p696 and the 2016 Annual Report (p35 in the unconsolidated and p85 in the consolidated).

It is quite difficult, then, to follow the development of both consolidated and unconsolidated Share Capital through from the base - p35 of the 2015 Unicredit S.p.A. unconsolidated Annual Report – to the situation at the date of the Reverse Stock Split.

The base was that "the share capital of the Bank is now €20,257,667,511.62, divided in 5,969,658,488 shares with **no face value**, of which 5,967,177,811 ordinary shares and 2,480,677 savings shares" [author's bold type].

Unicredit's share capital after the Reverse Stock Split
The picture is easier to follow as from the Reverse Stock Split. It took place on 23/1/2017 and the result was announced in another Press Release of that date:

Stage	Date	Share capital	Ordinary shares	Savings shares	Total shares
Up to 23/1/17	31/12/2015	€20,846,893,436.94	6,177,818,177	2,524,890	6,178,070,666
After 23/1/17	30/01/2017	€20,846,893,436.94	617,781,817	252,489	618,034,306

The shares existing after 23/1/17 had no par value according to the respective documentation, whereas the rights issue assigned a par value of €0.01 to the new shares issued.

The number of shares taken up in the rights issue, as per the Press Release of 3/3/17, was:

Share type	Pre-existing	Newly issued	Future total
Ordinary Shares	617,781,817	1,606,876,817	2,224,658,634
Savings Shares	252,489	0	252,489
Total shares	618,034,306	1,606,876,817	2,224,911,123

Holders of Savings Shares were not offered new savings shares but new ordinary shares.

This has led to an inexplicable reduction in the Share Capital associated with savings shares after the rights issue compared to before, despite the same number of savings shares being in issue after the rights issue as before, and their having the same nominal value afterwards as before, whatever nominal value that is:

Savings Shares before	Savings Shares after	Savings Share capital before	Savings Share capital after	Reduction in Savings Share capital
252,489	252,489	€8,516,697.58	€2,367,586.02	(€6,149,111.56)

The number of new ordinary shares issued was 1,606,876,817 (priced at €0.01), and the new ordinary share capital raised was €16,068,768.17.

Then the reduction in the savings share capital of (€6,149,111.56) has been added to the amount of new ordinary share capital raised of €16,068,768.17 to produce an amount of Unicredit's ordinary share capital going forward of €22,217,879.73.

Unicredit's share capital after the rights issue
As stated above, the Press Release of 3/3/17 published the new share capital of Unicredit S.p.A. after the rights issue as compared to the share capital following the Reverse Stock Split. The figures are reproduced in the first three lines of the next table.

The Press Release gave a partial view because it did not include Reserves – either before or after the Q4 2016 provisions.

The table below gives the picture that could have been issued, in which we have added the Share Premium to derive the Balance-sheet capital, and then added the unconsolidated Reserves as at 31/12/15 (in the absence of unconsolidated Reserves as at 30/9/16 from the Prospectus or projected Reserves for 31/12/16) to derive the Balance-sheet equity:

PUBLISHED NUMBERS plus 2015 Reserves

	Existing shares	**Rights issue**	**After rights pay-in**
Ordinary Share Value	€20,838,376,739.36	€22,217,879.73	€20,860,594,619.09
Savings Share Value	€8,516,697.58	(€6,149,111.56)	€2,367,586.02
Total Share Value	€20,846,893,436.94	€16,068,768.17	€20,862,962,205.11
Share Premium	€15,861,000,000.00	€12,983,564,681.36	€28,844,564,681.36
“Balance-sheet capital”	€36,707,893,436.94	€12,999,633,449.53	€49,707,526,886.47
2015 Reserves	€10,300,000,000.00	0	€10,300,000,000.00
“Balance-sheet equity”	€47,007,893,436.94	€12,999,633,449.53	€60,707,526,886.47

There are three problems with the result:

1. There seems, as stated above, to be no valid reason why the savings share capital amount should have been reduced;
2. If the proceeds of the rights issue have been allocated for €0.01 to ordinary share capital and for €8.08 to Share Premium, and the shares are fully fungible with the existing shares, then the existing shares should be accounted for in the same way;
3. It was false to state – as appears in the Prospectus and the Annual Report – that the new and the existing shares have no par value, when investors in the new shares have paid €0.01 and that amount has been booked to ordinary share capital.

The discrepancy between the “Share Capital” valuation line of the existing shares compared to the new rights issue shares is highly questionable. Recording the nominal value of the new shares at €0.01 requires the same valuation to be applied to the pre-existing 617,781,817 ordinary shares. Likewise the savings share capital should retain its previous figure and not be moved for 75% into ordinary share capital.

If it is true that shares were issued with no par value, that policy would be also highly questionable. The Annual Report and Prospectus both state in many places that the shares have no par value. Were it to be permitted, then an infinite number of shares could be issued, and they should, regardless of their number, be entered into the accounts with a zero value.

Actual Reserves position at the time the Prospectus was issued

It would have been perfectly possible for the Prospectus to project - and clearly - the unconsolidated profits of Unicredit SpA for the period 1/1/16 to 30/9/16, 1/10/16 to 31/12/16, and then from 31/12/16 until the issuance of the Prospectus (or the date of the pay-in of the rights or 31/3/17) – and to include in the projection the degree to which the PORTO and FINO projects had impacted Reserves.

The following could reasonably have been set out - with appropriate disclaimers – if the date of issuance of the Prospectus had been chosen as the final date in the series:

Reserves as at 31/12/15	€10,300 million
Profits for Q1-3 2016	€1,100 million
Profit on ordinary activities for Q4 2017 (estimated)	€400 million
Reserves at 31/12/16 without Porto-Fino adjustments	€11,800 million
Porto-Fino adjustments in Q4 2016	(€12,200 million)
Reserves as at 31/12/16 with Porto-Fino adjustments	(€400 million)
Profit for January 2017 (estimated)	€150 million
Reserves as at 31/1/17 with Porto-Fino adjustments	(€250 million)
Reserves as at 31/1/17 without Porto-Fino adjustments	€11,950 million

What is less explicable is why unconsolidated Reserves had gone down to (€2.5 billion) in the 2016 annual report and eaten up not just the Porto-Fino adjustments, and but another €2.1 billion over and above that. Absent these extra downward adjustments, Reserves as at 31/12/16 should have stood at (€400 million).

As well as the differences in the valuation of Reserves and instead of the manner in which Unicredit present their figures, it is our opinion that the entirety of the shares-in-issue should be accounted for in the way the rights have been accounted for, with €0.01 allocated to Share Capital and the remainder to Share Premium.

To tackle the Reserves first, the Prospectus could and should have projected Reserves at least to year-end 2016 in line with the year-to-date profits shown elsewhere in the Prospectus, and published a "before" and "after" as follows:

PUBLISHED NUMBERS plus projected Reserves at 31/12/16

	Existing shares	**Rights issue**	**After rights pay-in**
Ordinary Share Value	€20,838,376,739.36	€22,217,879.73	€20,860,594,619.09
Savings Share Value	€8,516,697.58	(€6,149,111.56)	€2,367,586.02
Total Share Value	€20,846,893,436.94	€16,068,768.17	€20,862,962,205.11
Share Premium	€15,861,000,000.00	€12,983,564,681.36	€28,844,564,681.36
"Balance-sheet capital"	€36,707,893,436.94	€12,999,633,449.53	€49,707,526,886.47
Reserves 31/12/16	(€400,000,000.00)	0	(€400,000,000.00)
"Balance-sheet equity"	€36,307,893,436.94	€12,999,633,449.53	€49,307,526,886.47

Then the Shares should only be valued at €0.01 and the remainder allocated to Share Premium.

Thus, in our opinion, Unicredit's "Balance-sheet capital" and "Balance-sheet equity" going forward should have read as per the table below if we are keeping to the (€400 million) figure for Reserves at 31/12/16.

CORRECT NUMBERS but still with Reserves at (€400 million)

	Existing shares	Rights issue	After rights pay-in
Ordinary Share Value	€6.177,818.17	€16,068,768.17	€22,246,586.34
Savings Share Value	€2,367,586.02	0	€2,367,586.02
Total Share Value	€8,545,404.19	€16,068,768.17	€24,614,172.36
Share Premium	€36,699,348,032.75	€12,983,564,681.36	€49,682,912,714.11
“Balance-sheet capital”	€36,707,893,436.94	€12,999,633,449.53	€49,707,526,886.47
Reserves 31/12/16	(€400,000,000.00)	0	(€400,000,000.00)
“Balance-sheet equity”	€36,307,893,436.94	€12,999,633,449.53	€49,307,526,886.47

The “CORRECT NUMBERS” above show an extremely low Share Capital and that 99.95% of “Balance-sheet capital” is composed of Share Premium. The very low Share Capital after the rights issue of €24,614,172.36 has a worse appearance than a Share Capital of €20,862,962,205.11, even if the “Balance-sheet capital” and “Balance-sheet equity” are unchanged.

Of course these “CORRECT NUMBERS” are not actually correct, because Reserves were not (€400 million) at 31/12/16. We will return to that issue later. The question of whether the Prospectus should have shown both the projected Reserves at 2016 year-end, and/or at the date of issue of the Prospectus, and/or at a date after the pay-in of the rights issue is one that could be debated, but since the timelags involved are one and two months only, we consider the question to be somewhat academic, the more so since Unicredit’s monthly profit is very modest compared to the size of the rights issue.

Multiple valuations of Unicredit’s shares

Instead let us turn to the choice of valuation of Unicredit’s shares in its “Balance-sheet capital”: it is not just between zero and €0.01, or between the accounting for the new and the old shares.

The documentation issued by Unicredit presents five possible par (or “face” or “nominal”) values, of which two arise solely because of the Reverse Stock Split: the valuation of €3.37 after the Reverse Stock Split is consistent with the one before it of €33.73 given that ten shares were exchanged for one.

In essence four possible par values were offered:

1. As if the shares had no par value;
2. As if the shares had €0.01 par value;
3. The par value derived from the Share Capital and number of shares in issue before the rights issue;
4. The par value derived from the Share Capital and number of shares in issue after the rights issue.

The difference between (3) and (4) shows the dilutive effect of a 13-for-5 rights issue.

The press release of 27/3/17 states that the New Shares have "the same characteristics of the outstanding Unicredit ordinary shares and with regular entitlement": this means they are fully fungible with the old shares and should be accounted for in the same way. Only one type of Unicredit share was and is now quoted on a stock exchange.

The press release of 3/3/17 showing the new structure of Unicredit share capital after rights issue contradicts itself in stating – against both the "Current share capital" and the "Previous share capital" – that the ordinary and savings shares had and have "no nominal value" – and then it assigns a value to them.

The documentation contains evidence to support each of the four valuations. However, whichever one is true, the other three must be false.

Valuation Option	Where evidenced
Zero (also termed both "no par value" and "no nominal value" across the different papers)	• Prospectus p695 • 2015 Annual Report p35 • Press release on Reverse Stock Split of 17/1/17 • Press release on successful subscription of rights of 23/2/17 • Press release showing new structure of Unicredit share capital after rights issue of 3/3/17
€0.01 – the accounting of the new shares under the rights issue	• The accounting of the rights issue • Press release announcing the terms of the rights issue of 1/2/17 • Press release showing the new structure of Unicredit share capital after rights issue of 3/3/17
€33.73 – the accounting of all the ordinary share capital after the Reverse Stock Split	• On-balance-sheet ordinary Share Capital after the Reverse Stock Split but before the rights issue • €20,838 million divided by 617.781.817 • Taken from press release of 17/1/17
€9.38 – the accounting of all the ordinary share capital after the Reverse Stock Split and after the rights issue	• On-balance-sheet ordinary Share Capital after the Reverse Stock Split and after the rights issue • €20,861 million divided by 2,224,658,634 ordinary shares • Taken from press release of 3/3/17

In our view the correct version is as stated in the previous section:

- All the shares should have a nominal value of €0.01;
- The new shares and the old shares are fully fungible and so must be accounted for identically, which would deliver a version post the rights issue as follows:

Ordinary Share Value	€22,246,586.34
Savings Share Value	€2,367,586.02
Total Share Value	€24,614,172.36
Share Premium	€49,682,912,714.11
"Balance-sheet capital"	€49,707,526,886.47
Reserves	(€400,000,000.00)
"Balance-sheet equity"	€49,307,526,886.47

However, this figure for “Balance-sheet equity” contrasts with the one of €60,707,526,886.47 that investors might have extrapolated from the Press Release of 3/3/17 and their assumption that Reserves were still €10.3 billion.

Of course Unicredit’s “Balance-sheet equity” had never been €60,707,526,886.47, because “Balance-sheet capital” only rose to €49,707,526,886.47 **after** the pay-in of the rights on 3/3/17, by which time the Reserves were no longer €10.3 billion but (€2.5 billion).

Impact of the Q4 2016 provisions on Reserves
Page 3 of the Prospectus gave a first taste of the bitter cup that had been proffered to the lips of the rights issue subscribers: it refers to “one-off negative impacts on the net financial result of Q4 2016 of €12.2 billion due to the increase in the degree of cover on the portfolio of loans subject to sale under the scope of the “Fino Project” and the impaired loans of the “Porto Project””.

Even this statement is not completely true: the provisions for Porto and Fino amounted to €8.1 billion of the total provisions of €12.2 billion, but it has suited Unicredit not to detail in this statement what the remainder was put to: this information is on p488. For ease of understanding we refer to the €12.2 billion of provisions as “Porto-Fino adjustments”.

Page of 2 of the same document refers to these two projects as being part of the Unicredit Strategic Plan for “the improvement of the quality of the assets”: all very positive.

It is only on the following page that there is clarity that this “improvement” is being bought – and indeed at the time the Prospectus was issued had already been bought - with nearly the entire proceeds of the rights issue.

At the time the Prospectus for the rights issue of €13 billion was issued, then, almost the entire amount had already been poured down the drain by Unicredit in the form of further loan loss write-downs, to decrease the value of loans that were being sold off into securitisation vehicles and to increase the Loan Loss Provisions against loans retained.

If that was not bad enough, any profits on operations since the 2015 annual report were also being used up. The Prospectus showed that Unicredit had only made a net profit of €1.1 billion in the nine months to 30/9/16, and it was reasonable to extrapolate that into a profit of €400 million on ordinary activities in Q4 2016, and one of €150 million in January 2017.

The 2016 annual report, when issued, showed that the unconsolidated Reserves of Unicredit SpA had fallen by €12.8 billion from €10.3 billion to (€2.5 billion), and that there was no profit in 2016 to cushion this blow. This is actually €2.1 billion worse than would have been expected had one added together the 31/12/15 Reserves plus the projections issued by Unicredit about its ordinary activities through the year plus the impact of the Porto/Fino adjustments. Ordinary activities were delivering an annualized profit of €1.5 billion, and putatively an extra €100 million after year-end but before the Prospectus was issued.

Instead an extra €2.1 billion has gone AWOL, reducing Reserves to (€2.5 billion) as per the 2016 unconsolidated annual report when it was finally issued.

The version that the Press release of 3/3/17 should have issued was as follows:

CORRECT NUMBERS but with Reserves at (€2.5 billion)

	Existing shares	**Rights issue**	**After rights pay-in**
Ordinary Share Value	€6.177,818.17	€16,068,768.17	€22,246,586.34
Savings Share Value	€2,367,586.02	0	€2,367,586.02
Total Share Value	€8,545,404.19	€16,068,768.17	€24,614,172.36
Share Premium	€36,699,348,032.75	€12,983,564,681.36	€49,682,912,714.11
"Balance-sheet capital"	€36,707,893,436.94	€12,999,633,449.53	€49,707,526,886.47
Reserves 31/1/17	(€2.500,000,000.00)	0	(€2.500,000,000.00)
"Balance-sheet equity"	€34,207,893,436.94	€12,999,633,449.53	€47,207,526,886.47

How very convenient that these PORTO-FINO loan losses were not recognised in the nine months to 30/9/16 – the period containing the principal figures supporting the offering of the rights.

How convenient that the rights issue was completed before the 2016 full-year results could be produced.

How convenient that an extra €2.1 billion of charges through the P&L could be taken in Q4 2016 and lost in the noise.

Indeed, it appears that Unicredit has capitalised upon a narrow window-of-opportunity to get the rights issue away before it had to formally unveil its Q4 2016 and Full Year 2016 accounts with the impact of the "Porto-Fino adjustments" clear for all to see, and managed to obfuscate the source of the extra €2.1 billion of charges via both the timing and the display of consolidated figures only.

Reduction in equity due to Porto-Fino adjustments

What it means for Unicredit's "Balance-sheet equity" is that, when the Press Release on 3/3/17 was issued showing the new "Balance-sheet capital" position, there was a failure to show the "Balance-sheet equity" position as well and reveal that the bank's reserves had been eliminated by the Porto-Fino adjustments and by the extra adjustments, which totaled €14.3 billion.

So, since the Press Release of 3/3/17 was careful to state that it reported "the current composition of the share capital" and did not state either (i) the Share Premium (ii) the Reserves or (iii) the totals of the Share Capital and any of the above, the result will have been opaque to many subscribers.

Indeed, whilst Unicredit has chosen to write the adjustments off against Reserves, the Reserves have various components, each one with its Account Chart and Accounting Rules behind it. Rather than expunge the Reserves, Unicredit could have chosen to write the Porto-Fino adjustments off against its Share Capital and/or Share Premium.

Had it written the adjustments off against Share Premium, it would not have had to disclose the write-off in the figures in the Press Release of 3/3/17. Share Premium would have reduced from €28 billion to €14 billion (under "Claimed position") or from €49 billion to €35 billion (under "Actual position").

Had it written the adjustments off against Share Capital, however, it would have had to disclose this in the Press Release, and shown Share Capital as €6 billion (under "Claimed position") or (€14 billion) (under "Actual position").

Unicredit's accounting policies around its capital also have their implications here, in terms of their showing any number at all against Share Capital if the shares really do have no par value: had the shares all been valued with either (i) no par value, or (ii) a €0.01 nominal value, and had the adjustments been taken against Share Capital, Share Capital would have shown a deficit of over €14 billion.

What it comes down to is disclosure: were investors led to believe they were recapitalising the bank and that its capital would rise by the amount of the rights issue? Was it made abundantly clear to them that "capital" would indeed rise but that "equity" would reduce because Reserves had already been wiped out and more before the Rights Issue Prospectus had been issued?

Section 3 - Unicredit treatment of foreign network and loan loss position

Unicredit treatment of foreign network
The Unicredit S.p.A. annual report as at 31/12/15 shows that Unicredit S.p.A. only had 7 branches outside Italy, but that it had "Financial Investments" of €46 billion, its second largest asset position after loans due from customers.

Unicredit is known as a major bank in Germany, Austria and Central&Eastern Europe (the "C&EE" as it terms it) as well as in Italy. In Germany it has Hypovereinsbank; in Austria it has BankAustria. Both are owned 100%, and have been restyled with the Unicredit name.

Unicredit's large network in the C&EE was historically owned through BankAustria, the latter having the #1 market position in Austria, and other C&EE operations having local profiles as follows:

Country	Market share %	Market position
Bosnia-Herzogovina	24.0	1
Bulgaria	19.9	1
Croatia	26.7	1
Czech Republic	10.3	4
Romania	7.7	5
Russia	1.6	10
Serbia	10.0	3
Slovakia	7.3	5
Slovenia	7.1	6
Turkey	9.6	5
Hungary	8.3	2

Unicredit has now altered the ownership structure such that there is no intermediate layer of ownership by a licensed bank (BankAustria) but rather by a non-bank holding company ("Beteiligungsgesellschaft"). The principle differences between the consolidated and unconsolidated "Balance-sheet equity" is the Reserves of the subsidiary banks, and any Minority Interests in the subsidiary banks. But at the end of it Unicredit Group only has one lot of Share Capital, Share Premium and its own Reserves, which comprise the "Balance-sheet equity" of Unicredit SpA individually.

That equity is being used to support the loan book of Unicredit SpA and all its other on- and off-balance sheet exposures, and it is being used again to do the same thing for the subsidiary banks in Germany, Austria and the C&EE countries.

Basel II and avoidance of double or triple leverage
The Basel II capital accords address this issue, for example in the Basel II consultative document of January 2001 Part 1: Scope and section A:
"The Accord will also apply to all internationally active banks at every tier within a banking group, also on a fully consolidated basis (see illustrative chart at the end of this section) (2)"

Footnote (2) states that "As an alternative to full sub-consolidation, the application of the Accord to the stand-alone bank (i.e. on a basis that does not consolidate assets and liabilities of subsidiaries) would achieve the same objective, providing the full book value of any investments in subsidiaries and significant minority-owned stakes is deducted from the bank's capital".

This last phrase is the key one: "providing the full book value of any investments in subsidiaries and significant minority-owned stakes is deducted from the bank's capital". Unicredit SpA should deduct the €46 billion invested in other banks from its own equity, to determine the amount of lending it can do itself. This would avoid double- or triple-leverage.

The objective of these rules is to avoid a situation where:

- Bank A has capital of 5, borrows 95, buys subsidiary banks B, C, D, E and F for 25, and lends 75 itself
- Then banks B, C, D, E and F – each with 5 of capital invested in them by Bank A – borrow 95 each as well and lend 100 each
- Then you have 575 of loans but only 5 of capital

Even worse if banks B, C, D, E and F do exactly what bank A did, and invest in further subsidiary banks who in turn borrow and lend. This was the previous structure where the C&EE banking subsidiaries were owned through BankAustria.

Instead Basel II restricts this by either (i) insisting on full consolidation and there being only one balance sheet and one lot of capital, or (ii) making each bank hold capital 1-for-1 against its asset in the shape of its investment in unconsolidated banking subsidiaries: the bank can then only inject its own capital into banking subsidiaries, not borrowed money, and its ability to borrow and lend to customers itself is restricted by its residual capital, that being its own capital less the capital it has injected into banking subsidiaries.

Unicredit SpA does neither.

Unicredit S.p.A. loan loss figures

Now we turn to the most pressing issues for Unicredit: the quality of its customer loan book in Italy, the provisions made against it so far, and the prospect that recoveries can be made on the loans that are large enough to coincide with the provisions.

The figures are quite confusing in the detail as they refer at length to adjustments made thanks to policy notes from the European and Italian banking supervisors.

Please note for this purpose the dictionary definitions of "past due" and "Non-performing":

Past due	a loan payment that has not been made as of its due date. A borrower who is past due may be subject to late fees, unless the borrower is still within a grace period
Non-performing	the sum of borrowed money upon which the debtor has not made his scheduled payments for at least 90 days. A nonperforming loan is either in default or close to being in default

Unicredit only records into NPLs those loans that are both Non-performing **AND** past due. In other words there may be more loans that are past due but have not yet reached the status of being Non-performing.

These figures are abominable as they are, and are high even for the Italian banking sector. Sector Non-performing loans were assessed by Mediobanca in mid-2016 as being 17% of bank balance sheets in Italy, or €360 billion.

Unicredit's accounting of provisions is not to carry the loans at face value on the Asset side, and build up a Provision for Bad & Doubtful Debts on the Liabilities side, charging the additions to the provision as an expense through the P&L account.

Instead it writes down the value of the loans from their face value (or nominal value) to a "carrying value". Additional write-downs of value are charged as an expense through the P&L account: the Porto and Fino adjustments were charged through the P&L account in exactly this way in Q4 2016.

Then the "carrying value" of NPLs is held in the accounts in line 70 together with the nominal amounts of all Performing Loans. It would be more helpful to have a line for NPLs separate from line 70, and then to see a "Provision for Bad & Doubtful Debts" as a liability. One could then readily assess the proportion of all loans that are on NPL status, and the percentage of NPLs held as a provision.

Even better if there were separate lines for "Non-performing and past due", "Unlikely to pay", and "Bad exposures" on the Asset side, and separate provisions against each on the Liability side.

This method of presentation would be much clearer than the one Unicredit uses.

As it is there are no provisions on the Liability side against the NPLs on the Asset side. Investors simply have to trust Unicredit's judgement that the "carrying values" on the Asset side realistically reflect what Unicredit can recover, and that there is some capital held against the "carrying values" as a result of their being run through Unicredit's Internal Risk-Based Approach to credit assessment and capital adequacy.

Unicredit also uses the terms "write-down" and "carrying value" as percentages of nominal value to the extent that there is a risk of confusion: "carrying value" is Nominal (or 100%) less Write-down.

Unicredit stresses the degree of write-down, e.g. on the Ex-FINO portfolio it is 56.57% as at 31.12.16. That sounds impressive.

However, that these loans are still valued at 43.43% of nominal sounds less impressive: are they still worth that much when the FINO loans have been sold off for only 13% (and may have been valued at even less than that)?

Impact of the "Porto Project" and the "Fino Project"
The meaning of the "Porto Project" and the "Fino Project" is thus that Unicredit has made further provisions against some of its Non-performing loan book (PORTO), and has reduced the value of another portion (FINO) in preparation for these loans to be sold off to special-purpose companies that would issue bonds to finance them and try to make a recovery. These loans will have been from within the €53.8 billion of Non-performing loans shown as the re-casted figure in the 2016 accounts for NPLs at 31/12/15.

The subject loans had already been written down to some degree before 31/12/15.

However the "Write-downs" of €29.5 billion for Non-performing loans as at 31/12/2015 on the whole NPL book were not deemed adequate to write the subject loans down far enough (i) for their "carrying value" to equate to the likely recovery on the loans Unicredit has retained, and (ii) for the investors to have been willing to take the ones Unicredit wished to sell.

A further hit of €8.1 billion was needed in order to close up those two gaps between the "carrying value" of the loans in Unicredit's books and their recoverable value.

How "PORTO" and "FINO" were addressed in the Prospectus
The Prospectus made clear to investors (p3) that the bank would take €12.2 billion of provisions in the fourth quarter 2016 results i.e. later than the most recent audited figures to hand and before the 2016 audited figures could be issued. €8.1 billion were write-downs on the loan portfolio, of which €3.6 billion pertained to the FINO project and €4.5 billion to the PORTO project (p488 and p599).

Investors were made aware (p130) that there was a risk of a higher write-down because the FINO project had not yet finally closed, it being a transaction to sell off €17 billion nominal value of non-performing loans NPLs.

The essence of the PORTO project (p608) was to increase the "coverage" of NPLs from 52.2% of nominal to 58.2% of nominal i.e. by 6%.

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NPL analysis in the 2016 unconsolidated annual report
The table on p33 of the unconsolidated 2016 annual report shows the relevant percentages against different classes of NPL. PORTO's essence was to increase the write-downs as a percentage of face value under "Total non-performing", to 56.57% from what it was at 31.12.15 – 52.31% (although this is not a difference of 6%). The carrying value thus reduced from 47.69% to 43.43%.

The FINO provision of €3.6 billion was applied solely to the portfolio of loans earmarked to the FINO project of €17 billion nominal. The write-downs as a percentage of face value under "Total non-performing" with the FINO portfolio included have increased to 66.21% from 52.31%, showing that the FINO portfolio has been written down even more aggressively than the remainder of the portfolio:

Loans to customers - Asset quality (€ million)

	BAD EXPOSURES	UNLIKELY TO PAY	NON-PERFORMING PAST-DUE	TOTAL (*) NON-PERFORMING	PERFORMING	TOTAL LOANS
As at 12.31.2016						
Gross Exposure	19,155	17,059	618	**36,832**	198,239	**235,071**
as a percentage of total loans	*8.15%*	*7.26%*	*0.26%*	***15.67%***	*84.33%*	
Writedowns	12,996	7,594	246	**20,836**	998	**21,834**
as a percentage of face value	*67.85%*	*44.52%*	*39.81%*	***56.57%***	*0.50%*	
Carrying value	6,159	9,465	372	**15,996**	197,241	**213,237**
as a percentage of total loans	*2.89%*	*4.44%*	*0.17%*	***7.50%***	*92.50%*	
As at 12.31.2016 ("FINO" portfolio included)						
Gross Exposure	36,200	17,059	618	**53,877**	198,239	**252,116**
as a percentage of total loans	*14.36%*	*6.77%*	*0.25%*	***21.37%***	*78.63%*	
Writedowns	27,832	7,594	246	**35,672**	998	**36,670**
as a percentage of face value	*76.88%*	*44.52%*	*39.81%*	***66.21%***	*0.50%*	
Carrying value	8,368	9,465	372	**18,205**	197,241	**215,446**
as a percentage of total loans	*3.88%*	*4.39%*	*0.17%*	***8.45%***	*91.55%*	
As at 12.31.2015 recasted(1)						
Gross Exposure	36,615	18,157	1,578	**56,350**	194,437	**250,787**
as a percentage of total loans	*14.60%*	*7.24%*	*0.63%*	***22.47%***	*77.53%*	
Writedowns	22,921	6,077	481	**29,479**	1,111	**30,590**
as a percentage of face value	*62.60%*	*33.47%*	*30.48%*	***52.31%***	*0.57%*	
Carrying value	13,694	12,080	1,097	**26,871**	193,326	**220,197**
as a percentage of total loans	*6.22%*	*5.49%*	*0.50%*	***12.20%***	*87.80%*	

The maximum nominal amount of NPLs is €56 billion, not €75 billion, and the table shows all of:

- Current NPLs without FINO
- NPLs with FINO
- Re-stated NPLs as of 31/12/15

This enables us to determine how far the FINO portfolio has been written down (numbers in € millions):

Portfolio	Nominal	Write-down	Write-down	Carrying value	Carrying value
Total	€53.877	66.21%	€35.672	33.79%	€18.205
Ex-FINO	€36.832	56.57%	€20.836	43.43%	€15.996
FINO	€17.045	87.04%	€14.836	12.96%	€2.209

In other words the FINO portfolio has been written down very aggressively.

It was held at only 12.96% of its nominal value, inferring that:

- These are the loans in the NPL book upon which the least hope can be set of a meaningful recovery, possibly entirely from “Bad Exposures”;
- “Bad Exposures” stood at €19.1 billion nominal in the 2015 accounts and at €36.6 billion in the 2016 accounts, a difference of €17.5 billion;
- If Unicredit can sell them off at above 12.96%, then it will be able to release that differential back into its P&L account as a profit.

This is not to say that the coverage of the remaining portfolio can now be regarded as adequate: it is just better than it was before PORTO.

The Prospectus p129 states that between 31/12/14 and the Prospectus date the bank had disposed of €12.66 billion nominal of NPLs which had been written down to €9.8 billion. These figures are not then tied back to the maximum nominal of NPLs - €75 billion - consistent with a write-down of 6% equating to the PORTO provision of €4.5 billion.

Impact of Q4 2016 provisions on Unicredit capital adequacy

A prime reason for the issuance of the Supplement was that Unicredit had breached its regulatory Capital Adequacy ratios for the period in between (a) when these charges were taken (Q4 2016) and (b) when the rights issue was paid in to replenish the bank’s capital, by a greater amount than predicted in respect of the Tier 1 capital ratio: by 2% instead of 1%.

The degree of non-compliance is shown in the Supplement p32, with the adjustment of the Tier1 capital ratio:

> **Based on the 2016 Preliminary Data, with** ~~With~~ reference, on the other hand, to the capital requirements based on the 2016 Preliminary Data applicable from 1 January 2017 (see Chapter 4, Paragraph 4.1.5 of the Registration Document), ~~it is expected that the following will not temporarily be complied with~~ **the following patrimonial requirements (*phase in*) are not** temporarily complied with:
>
> - The “OCR Requirements”[4]:
>   - the CET1 capital ratio (equal to 8.755%) by around 1 percentage point;
>   - the Tier1 capital ratio (equal to 10.255%) by around 1.~~5~~**2** percentage points;
>   - the Total capital ratio (equal to 12.255%) by around 1 percentage point;
> - relating to the “OCR Requirements + ‘Pillar 2 capital guidance’” (applicable only with reference to the CET1 capital ratio):
>   - the CET1 ratio (equal to 10.005%) by around 2 percentage points[5].

On p30 of the Supplement we have the exposition of the key CET1 capital ratio and how it had to be adjusted downwards as compared to what was contained in the Prospectus:

> The table below summarises the development of the RWAs and the Common Equity Tier 1 ratio (fully loaded), on a consolidated basis, as at 31 December 2015, 30 September 2016, 31 December 2017 and 31 December 2019. This balance sheet data has been restated (or calculated) on the basis of the new UniCredit Group perimeter, as illustrated in Chapter 13, Paragraph 13.1.2 of the Registration Document.

	As at			
(in billions of Euros; percent)	**31 December 2015 (pro-forma)**	**30 September 2016 (pro-forma)**	**31 December 2017 (estimated)**	**31 December 2019 (estimated)**
Total risk-weighted assets (RWAs)	361	362	389	404
Common Equity Tier 1 capital/risk-weighted assets (CET1 capital ratio)	~~13.46~~12.96%	~~13.71~~13.21%	12.0%	>12.5%

Once again the information is difficult to follow. If the ratio was 13.21% of €362 billion at 30/9/16, then the equity figure must have been €47.8 billion. If provisions of €12.2 billion were taken in Q4, then equity must have reduced to €35.6 billion at 31/12/16. Assuming risk-weighted assets stayed the same, this ratio would have fallen to 10.17%, but which ratio is it? 10.17% is:

- 1.415% above the supposed target for the CET1 capital ratio of 8.755%
- 0.085% below the supposed target for the Tier 1 capital ratio of 10.225%
- 2.085% below the supposed target for the Total capital ratio of 12.255%

The result is inconsistent with all the statements of non-compliance given in the Supplement.

Then there are two further problems:

1. Total consolidated assets at 31/12/15 were €860 billion;
2. Total consolidated assets at 31/12/16 were €859 billion.

The "risk-weighting" of the assets reduced them by €500 billion in value, or by 58%, and this for a bank whose risk-weighting methodology has led it to have 21.37% of its Italian loan book on non-performing as at 31/12/16.

Unicredit capital and provisions

Then we must move to the overall capital position of Unicredit, both on a consolidated and unconsolidated basis, and at the end of 2015 and 2016.

We can re-use the table from Section 2 above:

	Unconsolidated		**Consolidated**	
in € billions	**31.12.15**	**31.12.16**	**31.12.15**	**31.12.16**
Balance-sheet capital	36.2	35.2	36.2	35.2
Reserves	10.3	(2.5)	17.3	7.9
Balance-sheet equity	46.5	32.7	53.5	43.1
Provisions	3.6	4.4	11.0	11.7
Total own resources	50.1	37.1	64.5	54.8

Unicredit key asset positions

At the same time there were the key asset positions:

- At the unconsolidated level, the Italian customer loan book (70) and then the shares that Unicredit SpA owned in its banking subsidiaries (100);
- At the consolidated level, the total loan book including that in Italy (70), and the shares that the group owned in non-consolidated companies (100).

We have the figures for both 2015 and 2016.

At the unconsolidated level for 2015:

60. Loans and receivables with banks	22,062,498,699	21,865,747,058
70. Loans and receivables with customers	215,174,711,235	220,649,120,433
80. Hedging derivatives	6,405,356,900	7,842,137,399
90. Changes in fair value of portfolio hedged items (+/-)	2,309,155,751	2,626,300,944
100. Equity investments	45,847,175,443	50,339,369,659

And for 2016:

60. Loans and receivables with banks	22,349,104,335	22,062,498,699
70. Loans and receivables with customers	213,236,760,033	215,174,711,235
80. Hedging derivatives	6,095,890,529	6,405,356,900
90. Changes in fair value of portfolio hedged items (+/-)	2,063,730,158	2,309,155,751
100. Equity investments	42,935,070,306	45,847,175,443
110. Property, plant and equipment	2,340,731,470	2,405,407,416

At the consolidated level for 2015:

60. Loans and receivables with banks	80,073,334	68,730,127
70. Loans and receivables with customers	473,998,521	470,568,766
80. Hedging derivatives	5,368,364	9,114,167
90. Changes in fair value of portfolio hedged items (+/-)	2,641,257	2,873,397
100. Equity investments	6,576,603	6,479,456

And for 2016:

60. Loans and receivables with banks	74,691,847	77,436,995
70. Loans and receivables with customers	444,607,482	445,381,979
80. Hedging derivatives	4,514,597	5,270,149
90. Changes in fair value of portfolio hedged items (+/-)	2,357,447	2,641,257
100. Equity investments	6,158,551	6,576,605

Equity investments

The first point to make is that the equity investments at the consolidated level are much lower than at the unconsolidated level.

This is because they consist mainly of the shares that Unicredit SpA now owns – through a non-bank holding company - in Hypovereinsbank AG (Unicredit Bank AG in Germany), BankAustria (Unicredit Bank Austria AG), and the Central & Eastern European network banks that were formerly owned though BankAustria.

We can deduct line 100 in the consolidated accounts from line 100 in the unconsolidated accounts to ascertain the minimum figure that Unicredit SpA holds as equity in banking subsidiaries:

In € billions	2015	2016
Unconsolidated accounts	45.8	42.9
Consolidated accounts	6.6	6.2
Equity in banking subsidiaries	39.2	36.7

This is not to say that the figures deducted back are not also investments in banking subsidiaries and should not similarly be deducted back against Unicredit's equity: the aim here is simply not to overstate the case.

Loan book of banking subsidiaries
Further we can deduce the amount of customer loans (line 70) made out of the banking subsidiaries:

In € billions	2015	2016
Unconsolidated accounts	215.2	213.2
Consolidated accounts	445.4	444.6
Loans in banking subsidiaries	230.2	231.4

Deducting equity in banking subsidiaries from Unicredit SpA capital
Under Basel 2 rules, Unicredit SpA should deduct equity owned in banking subsidiaries from its own capital, on a 1-to-1 basis, before identifying the amount of capital it has in order to support a loan book of its own.

We assume for the purposes of illustration that all figures except Unicredit's capital were static between 31/12/16 and 31/3/17, and that the change in Unicredit's capital was due to receiving the rights issue proceeds of €13 billion (as per the Press Release of 23rd February 2017), so we can calculate Unicredit SpA's capital available to support its own loan book:

In € billions	31.12.15	31.12.16	31.3.17
Unicredit SpA capital position	46.5	32.7	45.7
Equity owned in banking subsidiaries	(39.2)	(36.7)	(36.7)
Capital available to support own loan book	7.3	(4.0)	9.0

The ratios of loans to equity in the banking subsidiaries appear healthy, with the proviso that the banking subsidiaries hold more than just the loans under line 70 in the accounts:

In € billions	2015	2016
Equity of banking subsidiaries	39.2	36.7
Loans made out of banking subsidiaries	230.2	231.4
Ratio of equity to loans	17.02%	15.86%

Proper capital adequacy against residual risks under NPLs
But Unicredit SpA's capital situation is even worse than it first appears.

The Prospectus may have warned investors on p130 of the risk to the FINO project of higher write-downs being needed to sell off the FINO portfolio to investors, but there is less specificity about the risks:

1. Of the PORTO write-downs being inadequate to bring the carrying value of the remaining NPL portfolio to the level of recoveries;
2. Of loans being recorded now as "performing" deteriorating into the classes ranked as NPLs.

A key issue here is Unicredit's risk-adjusted weightings of its performing loans: the group's assets are reduced by 58% between their nominal value and the value used to calculate the group's capital adequacy ratios.

Setting aside its other assets and the capital it should hold against them, and concentrating just on its line 70, it is not enough that Unicredit has written down its NPLs to a carrying value of its ex-FINO NPLs of 33.79% on average.

It then appears to be feeding this carrying value into its Internal Risk-Based Approach to calculate the amount of capital to hold against it, in the same way as it calculates the capital it should hold against its performing loans.

This is inadequate. The level of doubt as to the recoverable value of the NPLs requires that Unicredit hold capital against them in a much higher proportion than it holds against performing loans.

The following would be reasonable proportions to hold against the different gradations of NPL, and then against performing loans:

- 100% of the carrying value of FINO as these are clearly the lowest quality of NPLs, up to the date of sale;
- 100% of the carrying value of "Bad exposures"
- 50% of the carrying value of "Unlikely to pay"
- 30% of the carrying value of "Non-performing & past due"
- 12.225% of Performing Loans, as per the Basel Total capital ratio

Capital requirement and resources available to meet them
The capital requirements deriving from each of these elements as at 31/12/16 would then be, in € billions:

Element	Carrying value	Quotient	Capital
FINO	2.2	100%	2.2
Bad exposures	6.2	100%	6.2
Unlikely to Pay	9.5	50%	4.8
Non-performing & past due	0.4	30%	0.1
Performing	197.2	12.225%	24.1
Capital needed by Unicredit SpA to support line 70			37.4

Assuming that the asset and provision situations were static between 31/12/16 and 30/3/17, we can infer the following:

In € billions	31.12.16	30.3.17
Capital needed by Unicredit SpA to support line 70	37.4	37.4
Actual free capital available to Unicredit SpA	(4.0)	9.0
Capital deficit in Unicredit SpA	(41.4)	(28.4)
Buffer positions (Provisions lines 110 & 120)	4.4	4.4
Resources deficit in Unicredit SpA	(37.0)	(24.0)

Unicredit had a further €4.4 billion of "Buffer positions" which do not get counted as capital but which are not owed as liabilities to third parties, and this improves their situation somewhat.

The capital/resources deficit would rise as the capital needed to support other lines on the Asset side of its balance sheet is taken into account, as well capital to support:

- Operational risk
- Off-balance sheet business

The capital/resources deficit would fall if the bank was shown to have a much-improved risk-weighting methodology compared to the one that has left it with 21.37% of its customer loans on Non-performing status.

Unicredit eligibility to run a Basel Internal Risk-Based Approach

The capital/resources deficit at Unicredit SpA is severe.

Unicredit SpA only appears solvent because of its incorrect treatment of its equity investments in its banking subsidiaries.

Under the correct treatment the €36.7 billion that Unicredit S.p.A. holds in equity in banking subsidiaries would be available only to support the businesses of the Unicredit network banks: whether that is in itself adequate is another matter.

The equity-to-loans ratio in the banking subsidiaries looks satisfactory, but then these banks have other on- and off-balance sheet business, operational risk, and an Internal Risk-Based Approach to credit assessment – the type of Approach that has proven so unsatisfactory at the parent bank.

Secondly there is the question of the capital adequacy behind the residual, "carrying values" assigned to the NPLs at Unicredit SpA.

The "carrying values" should have high quotients of capital held against them because of the imponderability of recoveries on the loans.

Thirdly the level of NPLs is such that certainly Unicredit SpA, - and by implication Unicredit Group as well - should not be permitted to run a risk-weighted methodology at all i.e. a Basel Internal Risk-Based Approach.

In that case the bank would revert to the Basel Standard Approach, whereby the gross value of line 70 is the same as the net value of line 70: Unicredit – on a consolidated basis – currently reduces its gross assets by 58% in order to determine their risk-weighted value, against which it has to hold capital.

A bank with such a poor track record of evaluating credit risk should not be permitted to persist with its failed Internal Risk-Based methodology.

With the proper treatment applied to the equity investments, enhanced capital adequacy against NPLs, and performing loans treated under the Basel Standard Approach, Unicredit SpA would have had a capital deficit of €41.4 billion on 31/12/16 and of €28.4 billion on 30/3/17 compared to the levels required by banking regulation.

It is worth mentioning again that these deficits are calculated in relation to just two lines on the Asset side of the Unicredit SpA balance sheet:

- The €6.2 billion of equity investments on 31/12/16 that were backed out may in fact be in banking subsidiaries and may need to be backed in again, in whole or in part;
- Several other lines on the Asset side need to have capital held against them;
- Capital needs to be held against Operational Risk;
- The off-balance sheet aspect of Unicredit's business needs to have capital held against it.

In the author's opinion the elements that might raise the capital deficit have a higher likelihood and materiality than the one which might serve to reduce it: that Unicredit's loan book is actually of better quality than the carrying value of NPLs and its own Internal Risk-Based Approach have determined.

Will the Porto-Fino adjustments and the rights issue be enough to cleanse the NPLs of Unicredit SpA?

Probably not.

If the bank's credit policy was so poor as to allow 21.37% of its loan portfolio in Italy to go bad, there can be no comfort that the bank's loan book does not harbour:

- Loans in Italy held in the statuses "Unlikely to pay" and "Non-performing & past due" now but which can travel down from "Non-performing & past due" to "Unlikely to pay", and from "Unlikely to pay" to "Bad exposures"
- Loans in Italy that are past due but not yet officially non-performing as well
- Performing loans in Italy where forbearance techniques like capitalisation of interest and grace periods have been used to keep them in that status, but then these techniques become exhausted and the loans go past due, then into "Non-performing & past due" and so on
- Impaired loans exist in portfolios outside Italy, losses in which would feed through and deplete Unicredit's group equity

The strong possibility – which the ECB is enquiring into – that the FINO portfolio was valued at its date of sale even lower than 12.96% is proof positive of these concerns.

Conclusion

Unicredit continues to skate on very thin ice, as thin after the rights issue as before. The rights issue has not recapitalized the bank but simply allowed it to put through arbitrary provisions that adjust the “carrying values” of certain On-balance sheet assets downwards, but with no certainty that the new values represent amounts that can be recovered.

The FINO project must be completed at 12.96% of nominal value or higher, or else Unicredit will have to take another write-down on that portfolio and face very difficult questions about the provisions it already took on that portfolio – and on the current valuation of all of the rest of its loan portfolio.

Whether the remaining NPLs will pay back 43.43% of nominal value, whether the performing loans do not contains items upon which considerable forbearance has already been applied to keep them out of the NPLs, what the risks are in the other Asset lines than line 70, what risks sit in the balance sheets of the banking subsidiaries, what risks sit in the Off-balance sheet business of both Unicredit SpA and its banking subsidiaries… these are questions that must not be tested – for the bank’s survival - because there are inadequate “own resources” and current profitability to deal with further material adjustments.

As it is Unicredit SpA only has a capital buffer to support its own business at all because it is not compelled to deduct back from its capital the equity investments it has in banking subsidiaries. This is an anomaly and not in line with Basel II.

Were these investments to be deducted back 1-for-1, Unicredit SpA would be shown to have a major regulatory capital deficit. In actuality it does have that deficit: Unicredit SpA’s single amount of capital is being used twice, to support its own business and that of its banking subsidiaries.

The approach only obtains a fig leaf of credibility because the bank is permitted – or it permits itself – to reduce its nominal Asset footing by 58% in order to arrive at its “risk-weighted assets”, against which it applies its capital in order to determine whether it meets its regulatory capital thresholds.

A reduction of this magnitude between nominal value and risk-weighted value is not credible for a bank that has 21.37% of its customer loans in Italy on Non-performing. Even after PORTO and FINO the NPLs stand at €18.2 billion. This compares to the Balance-sheet equity of Unicredit SpA of €32.7 billion at 31.12.16 and of €45.7 billion after the pay-in of the rights issue, without deducting back the investments in banking subsidiaries.

A bank with such a poor methodology of credit risk assessment that has led to this situation should not be allowed to persist with an Internal Risk-Based Approach to regulatory capital, since this allows it to appear solvent by shrinking the apparent amount of risk.

Source documents

- "Registration document" or Rights Issue Prospectus
- Supplement to the Rights Issue Prospectus
- Unicredit S.p.A. 2015 unconsolidated Annual Report
- Unicredit S.p.A. 2016 unconsolidated Annual Report
- Unicredit S.p.A. 2015 consolidated Annual Report
- Unicredit S.p.A. 2016 consolidated Annual Report
- Press release of 17/1/17 "Reverse stock split of ordinary and savings shares"
- Press release of 27/2/17 "SHARE CAPITAL INCREASE OF UNICREDIT: SUBSCRIBED 99.8% OF THE OFFERING CORRESPONDING TO EURO 12,968,720,936.60 AT THE END OF THE SUBSCRIPTION PERIOD"
- Press release of 27/2/17 "EARLY ENDING OF THE OFFER TO THE MARKET OF THE UNEXERCISED RIGHTS"
- Press release of 3/3/17 "COMPOSITION OF SHARE CAPITAL AND NEW ARTICLES OF ASSOCIATION"
- Press release of 23/11/17 about the progress of the FINO project
- "Consultative Document - The New Basel Capital Accord" of January 2001 (regarding Basel II)
- "Basel III: A global regulatory framework for more resilient banks and banking systems" of December 2010
- "Basel III leverage ratio framework and disclosure requirements" of January 2014

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