

EBA Consultation Paper

**Consultation on Supervisory reporting on forbearance and non-performing exposures
under article 95 of the draft of Capital Requirements Regulation**

(EBA/CP/2013/06)

BSG comments

June 24th, 2013

BSG COMMENTS

BSG is in favor of the aim pursued, namely to empower supervisors with the appropriate tools to assess, on a comparable basis across the European Union, the level of non-performing exposures as well as of forbearance activities, by harmonizing their definitions.

EBA proposes a definition for those two elements, as well as specific reporting, in order “*to provide supervisors and colleges with a tool to monitor asset quality of banks’ book on a common basis, and provide crucial input for future stress tests*” as stated in the EBA annual report for 2012.

However, we would like to underline several issues, due to the complexity and innovation that these reporting requirements imply.

We strongly suggest further debate on these issues. The pursued objectives must be more clearly stated and the reliability and interpretation of the data gathered assessed.

In particular, regarding the forbearance definitions, we would advise to rely on the market discipline through disclosures and analyze the external financial disclosures that will be made in Banks 2013 financial statements (and those already made in 2012), following the ESMA public statement on forbearance practices (ESMA 2012/853), in order to identify the different and the best practices on that issue, with the aim to propose a more widely accepted definition and relevant disclosures, in line with banks practices, as well as supervisory objectives and market transparency objectives.

- **Objectives and definitions of forbearance and non-performing exposures**

We understand the aim to define precisely these notions to facilitate comparability. However, we think the notions should be more clearly and consistently defined with either the CRR concepts and definitions or the accounting concepts and definitions. We express some concerns regarding both the definition of forbearance and the definition of non-performing exposures.

Forbearance definition

The definition is not sufficiently principle based and is not clearly articulated with current definitions and thus seems to introduce complex rules in regards to existing concepts in accounting principles or in the CRR.

The definition of default in the CRR article 174 includes the notion of restructuring due to financial difficulties as it points out that elements to be taken as indications of unlikeliness to pay include, among others, when “*the institution consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or, where relevant, fees. This includes, in the case of equity exposures assessed under a PD/LGD Approach, distressed restructuring of the equity itself*”.

It is worth to note that from the application date of the CRR, the definition of default will be used not only in the IRB approach, but also in the standardized approach, as the CRR replaces past due items with the term of defaulted items and refers to the definition of default in the IRB.

The notion of forbearance is not defined as such in IFRS accounting principles. However, in paragraph 59 of IAS 39 on financial instruments, the indicators of objective evidence of impairment includes when c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, is granting to the borrower a concession that the lender would not otherwise consider.

IAS 39.AG84 refers to renegotiations or other modifications of the loan contract due to financial difficulties of a borrower or issuer and the impacts it has on the way to measure impairment. Furthermore the guidance IG 4.3 “Assessment of impairment: Principal and interest” provides with some examples of restructuring due to financial difficulties of a borrower.

In both the CRR and accounting principles, the forbearance is associated with notions of defaults and impairment.

IFRS 9 impairment principles (Exposure Draft on expected credit losses - March 2013) will introduce additional expected losses provisions, if there is a change in credit quality since initial recognition of assets (switch from a 12 months expected losses recognition to a lifetime expected losses recognition). An instrument subject to lifetime expected losses recognition could be subject to a restructuring, without being in default. Is the aim of EBA to capture these types of forbearance (ie those in stage 2 lifetime expected losses subject to a restructuring)?

Restructuring for financial difficulties might occur before a default takes place, in order to avoid such a default. Such renegotiations might not be captured in the reporting, depending on the bank policy for the identification of forborne exposures. Furthermore, following a restructuring, a loan can no longer be in default. These situations are highlighted by disclosures provided by some preparers in their disclosures on forbearance or in the ESMA Public Statement on the treatment of forbearance. Is the aim of EBA to capture these types of restructuring?

As a conclusion, we believe that the concept itself raises many issues. Creating an asset class for reporting purpose that is not aligned with accounting or prudential definitions (defaulted or performing loans) is a major operative and conceptual difficulty.

Considering the above issues, we think that additional discussions are needed before proposing an agreed definition of forbearance.

In order to do so, we think it is important to refer to ESMA Public Statement - Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions (ESMA 2102/853) published on December 20th 2012 that defines forbearance as follows: *“forbearance measures occur in situations in which the borrower is considered to be unable to meet the terms and conditions of the contract due to financial difficulties. Based on these difficulties, the issuer decides to modify the terms and conditions of the contract to allow the borrower sufficient ability to service the debt or refinance the contract, either totally or partially.”*

ESMA completes the definition with examples, which illustrate the definition in a more comprehensive way. Furthermore, ESMA is clear that a forbearance (restructuring for financial difficulty) does not systematically give rise to an impairment loss.

We think that relying on a common definition with ESMA would enable to ease operational constraints.

As stated in the introduction above, we think that EBA should analyse the financial disclosures that will be published in 2013 (and those already published in 2012), following the ESMA recommendations for qualitative and quantitative disclosures on forbearance, for which ESMA expects that they will be implemented and reflected in Banks 2013 financial statements. In our view, these disclosures would need to be discussed and shared, before finalizing any reporting supervisory requirements on that matter.

Thresholds:

Thresholds enable harmonization of reporting all over Europe. However, even with thresholds, there is latitude on interpretations on whether a restructuring is a commercial one or is attributable to financial difficulties. There might be some different interpretations from one bank to another.

Shouldn't a threshold be introduced regarding the counterparty rating, in order to consider that below a given rating, a restructuring is considered to be a restructuring for financial difficulties?

Refinancing concept:

The notion of refinancing (as defined page 16) does not seem to be sufficiently defined to understand what needs to be captured. Is the idea to capture new money injected? Is there a real need to identify this part, as long as the forbore exposure is already reported through a debtor approach (as opposed to a transaction approach)? An alternative could be to have a “debtor” approach for all exposures, even for the retail exposures.

Non-performing exposures definition

The definitions in the CRR might be different (notion of unlikeliness to pay) from the one in the accounting standards (under IAS 39 an financial asset or a group of financial assets are considered as incurred if there is a loss event (events occurring after initial recognition) which has an impact on the estimated future cash flows of the instrument (cf IAS 39.59).

However, EBA proposes a new definition with some rules, without clearly defining a principle nor the aims pursued through the rules introduced.

The introduction of these new rules in the definition raises some operational complexity and they are not aligned with the European regulation.

As an example, entities current thresholds are between 90 and 180 days for considering an exposure as in default. We understand the aim of common thresholds of 90 days which seems conservative, but Article 174 (1) b) ensures the option for the competent authorities that in case of IRB banks they could replace the 90 days by 180 days for exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to public sector entities (PSEs).

Incurred but not reported losses as non-performing

The notion of incurred but not reported losses is not defined (page 12) nor detailed. The project highlight that “Exposures with “incurred but not reported losses” shall always be considered as performing exposures”. This appears in contradiction with IAS 39 standards which explains in AG 90 that impairment loss should be recognized in some cases for incurred but not reported cases^a.

Transaction versus Debtor approach

The CP clarifies page 13 and 30 when the assessment of non-performing exposure shall be performed based on a transaction approach (retail exposures) or a debtor approach (non retail exposures).

^a AG90: *as an example of applying paragraph AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.*

It furthermore defines thresholds for “contagion” of all the exposures of a debtor and points out that “*when a debtor has exposures past due more than 90 days representing 20% of all its exposures, or when the past-due amounts for this debtor represent 5% of its total exposures, all on- and off-balance sheet exposures to this debtor shall be considered as non-performing.*”

We understand that the aim is to define thresholds on contagion, but we question the relevance of choosing those amounts. In our view, it would be very burdensome if new approaches were created. We think the CRR, when defining “default”, also states that the debtors approach is the general rule, and the facility level approach may only be used for retail exposures. We think that the categories used for the definition of default should also be valid for the supervisory reporting presented in the CP. We do not think that new limits should be created.

Same thresholds for retail and corporate exposures

We question whether it makes sense to have the same thresholds for retail and corporate exposures (30 days for forbearance and 90 days for non performing). In some countries, the notion of doubtful loans depends on the nature of the asset, with different thresholds being defined to consider it doubtful. In our view, the retail and non-retail exposures must be treated in accordance with the CRR and the definition of threshold, if any, must be left to the institutions.

- **Scope of application:**

We are not in favor of including the trading book in the scope of this reporting: we consider that requiring a report on forbearance in the trading book would entail heavy procedures and high costs, whereas it would not provide relevant data to the supervisor.

We may understand why the scope is large with regards to the final aim of these reporting on forbearance. Indeed, we understand that regulators might be willing to have an exhaustive view on sovereign instruments for example, whatever their accounting classification.

However, depending on the way instruments are managed, they have a different prudential classification. We think that at a minimum the reporting should differentiate positions held in trading book versus those held in the banking book.

Furthermore, as the reporting does not take into account derivatives and credit derivatives among others, it does not represent the real net exposure institutions may have on counterparty.

For example, in the credit trading book where sovereign securities or corporate bonds can be hedged with purchases of protection, within the trading limits attributed to the desk, we understand that only securities positions would be reported and not derivative positions, omitting thus to report derivative positions which can reduce the exposure or derivative positions that can increase significantly positions (ex: written CDS).

Moreover, as these securities are reported in market value, the volatility in the reported figures would make it difficult to understand where the observed changes result from the volume of forbearance or market prices volatility.

In conclusion, we consider that requiring a report on forbearance in the trading book would entail heavy procedures and high costs, whereas it would not provide relevant data to the supervisor.

We agree that prudential Banking book at FVTPL should be included. We think it is important not to limit this reporting to instruments measured at amortized cost or fair value through OCI in the accounting: for example, exposures that an underwriter did not succeed to place in the market are recognized at FVTPL in the accounting. They represent credit exposures for the bank and need to be reported.

We agree that prudential Banking book at Fair Value Through Profit or Loss (FVTPL) should be included in the reporting. We think it is important not to limit this reporting to instruments measured at amortized cost or fair value through OCI in the accounting. For example, exposures that an underwriter did not succeed to place in the market are recognized at FVTPL in the accounting. They represent credit exposures for the bank and need to be reported if the regulator aims at obtaining an exhaustive view of institutions credit exposures.

Reporting considerations

The reporting requires the reporting of “Accumulated impairment, accumulated changes in fair value due to credit risk and provisions” but we question this request.

Indeed, instruments recognized at amortized cost are subject to impairment, in case there is objective evidence that the instrument is impaired. From a management perspective, these instruments are monitored to identify and track potential evidence of impairment, whereas instruments recognized at fair value are managed on a fair value basis and all fair value changes are recognised in P&L, without an identification of components attributable to credit risk.

For available for sale instruments, in the current IAS 39 accounting standard applicable in EU, the impairment loss, if any, to be recognized in P&L corresponds to amounts previously recognized in other comprehensive income, and the accounting standard does not require identifying separately components attributable to credit risk.

The disclosure of the fair value component attributable to credit risk is highly judgmental. Indeed, the split between credit risk, liquidity risk and interest rate risk is not really observable.

- **Consolidation scope:**

We question the relevance of relying on an accounting scope, whereas FINREP and COREP are based on a prudential scope. We may understand the willingness to have a global overlook of exposures of institutions, whatever their business is, provided that it truly makes sense. We are not sure for example that aggregating banking exposure and insurance asset held as reserve is relevant at all.

- **Implementation date:**

We understand the aim of having unified reporting among European entities. However, the rules imply different definitions from those used from an accounting standpoint and from a prudential standpoint and thus implicitly required by ESMA, raising some complexities in the reporting implementation.

Identifying all the contracts with forbearance measures would be time consuming and require significant changes in business process and IT development, if the definitions remain different from the one currently used from an accounting or from a prudential standpoint.

As IT developments will be required and as complexity arises from definitions which are neither prudential one nor accounting one, a one year delay after the publication of this RTS in the Official Journal might be necessary for the entities to be able to report the data.