



BANKING STAKEHOLDER GROUP

CONSULTATION ON EBA/CP/2015/15 ON GUIDELINES ON THE
APPLICATION OF THE DEFINITION OF DEFAULT UNDER ARTICLE 178
OF REGULATION 9EU0 575/2013

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

London, 22nd January, 2016

Foreword

The EBA Banking Stakeholder Group (BSG) welcomes the opportunity to comment on the Consultation Paper 2015/15 on Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013.

This response has been prepared on the basis of comments circulated and shared among the EBA Banking Stakeholder Group (BSG) members and the BSG's Technical Working Group on Capital and Risk Analysis.

This response outlines some general comments, as well as our answer to the eleven questions in the Consultation Paper.

General comments

The BSG welcomes the opportunity to comment on the Consultation Paper EBA/CP/2015/15 (draft GLS). As in the past, the BSG supports any initiative that aims at harmonizing supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups.

The application of the definition of default has been recognized as one of the areas that largely contributes to the discrepancies in the RWA calculation, particularly when internal models are used. The heterogeneity in this application is due to a large extent to different supervisory practices and national regulations. Consequently, the Basel Committee has considered, among the potential measures to develop in order to reduce the excessive variability in capital ratios, the promotion of more consistent implementation of existing standards in several areas, including the definition of default. Proposals by the global banking standard setter to increase the comparability of outcomes when internal models'-based approaches are used for credit risk are expected during 2016 and could include some provisions in relation to the definition of default.

The EBA is proposing these guidelines that complement the RTS on the materiality threshold of credit obligations past due in accordance with Article 178(6) of the CRR, in order to promote harmonisation in relation to the application of the definition of default at a European level. We consider that consistency with global initiatives should not be neglected, even if it means a delay in European initiatives in order to accommodate the pace and content with global initiatives. This is

particularly relevant in this case, given the potential impact and operational burden associated with implementing any change in the definition of default (it being a core element for the estimation of risk parameters when internal models are used for regulatory purposes).

The BSG believes that regulators should maintain some flexibility given to expert judgment for the definition of default. The subject of the definition of default is very sensitive: inappropriate proposals could disconnect the prudential status of the default of the economic reality of the counterparty. Thus a customer not in default due to financial difficulties but because of an inadequate definition of default (technical default due to trade disputes, for example) may struggle to secure refinancing. Moreover, this would conflict with the "use test" of the Basel framework. It would be more risk-sensitive to keep a flexibility expert judgment for specific cases.

In addition, the European Commission is working on a European label securitization "Simple and transparent Standard (STS)". Among the criteria proposed for this label, the Commission proposes to exclude any defaulted exposure (as defined in Article 178 of CRR) in the pool of the securitized exposures. As a result of this, the range of non-eligible counterparties in securitization transactions could well suffer.

The BSG would like to point out that many of the suggested changes will require significant system changes as well as calibration and in many cases redevelopment of internal models. It is therefore of utmost importance that significant time is allowed for the adoption of the new regulations in order for institutions to be able to handle all necessary changes and to obtain supervisory approval for the changes made. To adapt to the new definition of default our assessment is that at least 2-3 years will be required, excluding time for competent authorities to assess material changes. The time necessary for obtaining supervisory validation of the banks' internal model, where needed, should be factored on top of that.

It will also be essential to implement the new definition of default at the same time as the review of all internal rating methodologies.

The BSG would also like to mention that even though it supports initiatives to harmonize supervisory rules and practices, not all definitions and practices can be harmonized due to national discretions and legislative differences.

The BSG stresses that it is important to keep consistency in the default definition not only between institutions but also between different regulations. It is therefore

important that the proposed guidelines on the application of default are in line with similar definitions under the accounting framework or IFRS 9. This would prevent undue complexity and improve the comparability of the disclosed information.

- the reference to the overall level of leverage of the borrower must be qualified more precisely. It would be counter-intuitive to be penalized for funding a client that has improved its credit quality

- daily basis counting past due: it is said that the historical counting should be done on a daily basis. This type of metering provides a strong potential volatility of results and it can generate very heavy IT charges to properly account for exposures to customers / debtors: this would apply in particular to factoring. The BSG recommends the possibility of producing the process of identification of default at month-end only (any customer who has breached the materiality threshold for 90 consecutive days in the middle of the month will still be considered as part of the defaulting population regardless of whether or not the customer is back within limits before month end).

Replies to Questions

1. Do you agree with the proposed definition of technical defaults?

Do you believe that other situations should be included in this definition?

If yes, please provide detailed proposals on how to address further possible situations.

The definition of technical default is too restrictive: in fact all non-payments not due to credit reasons are considered in default with the exception of two cases cited in the consultation document.

It would mean a major change from the current practice of non-retail activities where no definition is given and where expert judgment is used to determine whether a past due status relates to a technical default or not.

The approach proposed by the EBA requires a much broader definition of qualified

technical default situations, e.g. resulting from the exposure past due being more than 90 days but not due to credit deterioration of the counterparty.

We offer a list of those situations that can be added to the definition of technical default:

- commercial litigation with a client in the case of the leasing business where the quality of the product / service rendered is disputed,
- lengthy administrative procedures to authorize payment (local authorities),
- logistical issues for the energy and commodities funding or more generally for the financing of trade finance: reasons that lead to delivery delays: the goods blocked at customs, the prohibition to entering or leaving ports, strikes, etc,
- disputes concerning the amount or nature of the collateral in the event of margin calls,
- the specific case of sovereign counterparties, for which default should be assessed at the political level,
- in general, “force majeure” (environmental disasters, measures imposed by law, riots, strikes, wars, etc).

In addition, trade disputes are resolved over long periods (often several years) which would mean that the borrower in default would remain so throughout this period.

However, the BSG believes that this approach may be acceptable for application to the retail business where a more mechanical approach seems more appropriate.

Another risk of this definition is too restrictive to reduce the relevance of the models and reduce the incentive to "use test". This is likely to significantly increase the default rate and therefore the “expected” cost of risk in the bank.

The BSG is concerned that the definition of technical default is limited to error in data or IT system of the institution (paragraph 3.2.2, first bullet on page 7). Technical default could also be the result of error in data or IT system of the counterparty. It would be very unfortunate not to include these technical defaults, particularly for large corporates, as technical defaults could be fairly frequent compared to actual defaults for some segments of counterparties. This could have an impact on both credit risk modelling (issues finding relevant risk drivers) and the

reasonableness in reporting of large exposures (risk of reporting large, well known counterparties as defaulted due to error in data or IT systems).

The BSG agrees with the definition of the second criteria of technical default regarding long payment allocation process within the institution (paragraph 3.2.2, second bullet on page 7).

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

The BSG appreciates that the EBA gives credit to the specificity of the factoring business

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

The BSG welcomes the EBA's proposal to anticipate the implementation of IFRS 9 and leverage as possible to the accounting framework.

Stage 3 of IFRS 9 includes exhibitions that are credit-impaired (e.g., in case of significant financial difficulties of the debtor, breach of contract, concession due to financial difficulties, the probable bankruptcy of the borrower etc.). Accordingly, the BSG agrees that stage 3 exposures will generally be considered in default.

However, while exposures in default would end in Stage 3 under IFRS 9, the reverse may not be true. There could be situations where some stage exhibitions 3 are not in default defective, for example when national options exist, but also for some technical defaults (see answer to question 1 above)

Furthermore, if the clarification provided by the EBA that losses "incurred but not reported" (IBNR) should not be considered as an indication of unlikeliness to pay (§ 26 of the PC), the BSG considers that this clarification should include Phase 2 of IFRS 9. Indeed, beyond the IBNR is a current concept of IAS 39, it should be made clear that IFRS 9 Stage 2 should not be considered a default indication.

The BSG would like a clarification regarding suggested probation period for exposures with incurred partial losses.

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

The rule on the sale of credit obligations seems very restrictive because a simple reduction [5%] of the nominal value would induce a default of the debtor and the contagion effects linked to its other exposures within a banking group.

This is too restrictive. The BSG recommends to increase the minimum threshold at least to the level of 10 % as the proposed threshold of 5 % is considered too low.

Moreover the BSG believes that the judgment of experts should be included in this assessment. Also that this calculation could be seen as another criterion of likely unlikelihood to pay but should be combined with other indicators.

The BSG also stresses the importance of harmonizing the guidelines with IFRS 9 (see general comments).

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

The BSG agrees that cash flows should be discounted with the customer's original effective interest rate. The specification could perhaps be clearer regarding how to handle any situation when the original effective interest rate is not available or in the case of variable rates.

However, the BSG is sceptical about the proposed very low threshold of 1% decline in the NPV. Article 178(3)(d) CRR considers “material forgiveness [...] of

principal, interest or, where relevant fees”. The proposed threshold seems not to be consistent with the materiality criterion and should therefore be set at a significantly higher level.

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

The BSG does not agree that the purchase or origination of a financial asset at a material discount should always be treated as an indication of unlikelihood to pay. The material discount could, for example, be the result of negotiations, changes to market conditions, or that the LGD of the financial asset is very high (low collateral value). In the event of an unlikelihood to pay for purchased or originated financial assets, this should also be reflected in the PD for the obligor.

This proposal would trigger a default for reasons that are independent of the risk of the counterparty credit. It is not compatible with the incentive to use Basel parameters for assessing credit risks.

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

The BSG does not believe that it is appropriate to specify fixed probation periods for different exposure classes; for distressed restructuring or for any other indications of default. The BSG believes that it is unnecessary to set fixed probation periods and suggests that the recognition when a customer is no longer in default should be up to each institution.

Changing the treatment of the probation period on historical defaults will be challenging in the recalibration of IRB models, especially if different probation periods are applied to different types of default events. For this reason it is suggested to limit the proposed changes to defaults occurring after the implementation of the new guidelines.

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

The BSG agrees with the proposed approach.

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

The BSG does not believe that a pulling effect should be introduced for retail exposures where the default definition is applied on facility level. The introduction of a pulling effect would diminish the purpose of applying default on facility level and would most likely reduce the predictability of PD models.

Instead the BSG suggests that institutions should be requested either to;

1. demonstrate that a default on a single facility does not have an impact on the probability of default for other facilities to the same counterparty; or
2. handle pulling effect as a part of the model specification, i.e. include the occurrence of a defaulted facility as an explanatory variable in the PD-model on facility level

In some cases the identification of defaulted exposures within credit facilities is not clear: for example, when a payment of a home loan is automatically assigned to another credit institution. Some banking arrangements stipulate that some overdrafts may be automatically offset by cash from another account.

The BSG also believes that the legal confidentiality restrictions could prevent the possibility of consolidating the defaults between different legal entities of the institution.

Finally, the rules for calculating past due days and the materiality threshold would be difficult to define and implement. The application of this approach would be operatively pulling effect very expensive.

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

The BSG estimates that such a mechanical and automatic process should be undermined by judgments and expert opinions.

Moreover, a global reflection on the materiality thresholds may be considered insofar as it may raise issues of competition between Member States (e.g. in France there is presumed significantly past due from the first € 1 by default).

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

The BSG agrees to the proposed approach.

As a point of attention, the BSG emphasizes that the Basel Committee has already issued guidelines on the credit risk management process to be applied following the application of IFRS 9. It is essential to be sure that there will be no contradiction between the two sets of requirements.

Submitted on behalf of the EBA Banking Stakeholder Group

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