German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on CP on guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013

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Comments on CP on guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013

On 22 September 2015 the European Banking Authority (EBA) published the consultation paper "Guidelines on the application of the definition of default under Article 178 of Regulation EU 575/2013". We welcome this opportunity to express our opinion.

I. General comments

Critical evaluation of the underlying requirements

We welcome the consultation paper's underlying thoughts of harmonizing supervisory law, supervisory reporting and accounting in the context of the definition of default. However, the various fields of application have different underlying objectives. Thus, harmonization is not always possible. The proposed specification of the default definition will trigger considerable adjustment needs for all banks in Germany. This will apply in particular if historical data are no longer used or have to be adjusted. Therefore sufficiently long implementation periods should be allowed for institutions so that they can carry out the required process and method adjustments. Waiving the parallelism of two different default definitions could reduce the implementation costs. Institutions should not be penalized at least during the implementation period if they are not yet able to fully comply with individual parts of the guidelines. An incremental introduction and implementation of the guidelines in the jurisdictions may be expedient.

At the least, the dates stated in the discussion paper "Future of the IRBA" (adoption of the guidelines by mid-2016 and 2.5-year implementation phase) should also apply for this consultation paper.

In addition, it should also be taken into consideration that after introduction and implementation of the new guidelines corresponding data histories of the default time series will first have to accumulate before they can be used as an anchor point in the rating procedure. In the transition phase, during which the new guidelines on default definition will have already been implemented but no data histories of sufficient length are available for validation or calibration, institutions should be entitled to adopt a flexible, albeit fully justified approach. A twofold registration of the reasons for default with the old and new default definition will even only temporary not be possible or will entail such expense which go beyond tolerable limits for the institutions.

Furthermore, no retrospective registration of the default reasons as per the new guidelines will be possible. Therefore, retrospective requirements should be dispensed with in their entirety.

This consultation paper will – also in conjunction with the changes planned as per draft RTS on materiality threshold of credit obligation past due of 31.10.2014 – probably lead to relevant changes in the default definition. Accordingly, existing default time series used by German banks for developing, validating and calibrating all the PD, LGD and EAD rating systems will probably have to be adjusted quite significantly. Since this cannot be implemented retrospectively, it will take some 1 to 2 economic cycles (five to ten years) before this is completely rectified.

In addition, it is to be expected that all the PD, LGD and EAD rating models will probably have to be redesigned or at least recalibrated to accommodate the aforementioned adjustments to the time series. Where IRBA rating systems pursuant to Delegated Regulation No. 529/2014 (RTS for model expansions and/or modifications) are used, these changes in turn will make it necessary to have models submitted for acceptance again. Since the necessary further development of the models is not because of adjustments inherent in bank portfolios, but due to the supervisory requirements being redefined, we consider the imposition of penalties, e.g. in the form of conservatism mark-ups, to be unjustified. Corresponding penalties should be waived for a transition period of at least 5 years from the date on which the new rules for implementing the definition of default are introduced because of the differing default definition in the development population of the risk parameter models. Alternatively, the complicated rules for approving significant changes in rating procedures should be revised (para. 12 of the draft guidelines). Reliefs or simplified approval or acceptance processes for IRBA procedures would be helpful.

Moreover, we feel that the implementation periods need clarification. The deadline stated in para. 13 of the draft guidelines for applications for approval of model changes – which have to be submitted one year before the guideline comes into force and by a yet to be defined date at the latest – may apply solely to the guidelines-compliant implementation of the changed default definition. The need to change the risk measurement models arising from the changed definition of default can only be gradually determined by institutions and hence should not be made subject to that deadline. In particular, post-processing the default history, something which we reject, is extremely laborious – assuming it to be possible in the particular case at all – and the time involved must be taken into consideration appropriately.

We point out that the EBA's proposed concretization of the default criteria would give rise to certain problems for development-related business. In development-related business, a development bank frequently grants loans to final borrowers via a commercial bank which channels the loan from the development bank to the borrower. Depending on the type of development loan involved, the on-lending commercial bank or the development bank bears the default risk. In numerous development loans the on-lending commercial bank and the development bank share the resulting losses. In that case the development bank faces two risk positions in a development loan: one against the final borrower and one against the on-lending commercial bank.

Development loans serve a narrowly defined development purpose. If the final borrower cannot prove compliance with the development purpose, the loan has to be repaid. If he is not in a position to do so, this raises the question as to how the loss will be shared by the development bank and the on-lending commercial bank. In such cases, legal disputes may even ensue and the on-lending commercial bank ends up in payment default with the development bank because of the legal action. This leads to particular problems in the definition of default in IRBA, which we shall address within our specific comments in further detail.

The consultation paper repeatedly stresses that group-wide default is to be defined and determined within a group. Accordingly we favor that only core subsidiaries that conduct lending business in the narrow sense be involved. Alternatively, the scope of application could be limited to banks and financial institutions in the regulatory group of institutions (i.e. excluding providers of ancillary services).

The materiality threshold for 90 days past due is not covered by this consultation paper. In section 3.3.1 lit. c of the instructions for completing the QIS on default definition, the EBA says that default arises if the overdue amount exceeds EUR 200 for retail exposures and 2.5% of the total receivable, at least EUR 1,000, for non-retail exposures. Here too, the past due days are counted only after the materiality thresholds have been reached. We expressly welcome this change compared with the suggestions in draft RTS on materiality threshold of credit obligation past due of 31.10.2014 as a more meaningful economic days past due rule.

Overarching aspects

The consultation paper calls for a quantitative comparison in conjunction with the buying and selling of credit obligations, losses recognized for instruments measured at fair value and also restructuring losses

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so as to measure the significance of value adjustments and deriving default directly therefrom. Regardless of the specific form of the comparisons in question, it should be ensured that a similar threshold is applied for all comparisons. Due heed should be paid to the specific shortcomings and uncertainties in the measurement so as to suitably limit the number of false positives, i.e. positions wrongly classed as defaulting. We fear that the weaknesses of the selected measurement methods will make this type of error very high in the light of the levels (1% and 5%) proposed in the consultation paper.

The methods proposed in the consultation paper will not determine the economic change in value triggered by the credit risk. Significant deviations from this target variable could be caused, for example, by interest-rate effects, liquidity aspects, strategic decisions, use of non-present value approaches, present value methods in the various accounting standards and suchlike.

For that reason, using the proposed approach without allowing for the aforementioned aspects leads to a distortion of the default event, because even obligors with a good credit rating might possibly be classified as defaulting.

Furthermore, implementing the required calculation would entail considerable technical and functional effort. In particular determining present values requires a great deal of effort which would lead to unreasonably high costs, especially for smaller institutions. The majority of institutions would find themselves confronted with additional procedural workload beyond all reasonable bearing to the supervisory benefit.

In addition, it should be borne in mind for all the criteria for default that these need not necessarily apply for all the transactions of a given obligor. Hence conflicting constellations are conceivable, such as a) differently pronounced relative fair-value changes in different exposures to an obligor, b) pronounced relative fair-value changes in one exposure, and another exposure for the same obligor in Stage 1 pursuant to IFRS 9 with an altogether average rating for the obligor, c) sale of different exposures of an obligor with highly different mark-downs. Whilst there are no rules in the draft guidelines covering such constellations, the shortcomings and inconsistencies in the method to determine impairment, for example, nevertheless do not permit the decision in constellation b) to be grounded solely and alone on the fair-value change.

Due to the dilution of the change in value measurement by a large number of influencing factors beyond the credit risk in the approaches specified in this consultation paper and the very high expected workload for implementing the requirements, we do not consider implementation of the proposed methods and thresholds for change in value measurement so as to permit a deterministic classification of default as reasonable. Alternatively, where exposures are sold for example, it could be assessed whether there would have been an individual impairment adjustment on the exposure without the sale transaction and use the outcome of that assessment to determine default or not.

The group-wide calculation method specified in the draft guidelines concerning the materiality threshold for 90 days past due would require a real-time group-wide data repository for all exposures. Therefore, where the default definition is applied in a group of institutions, it should be possible to carry out the computations for the materiality threshold for 90 days past due at the individual institution level. Only after a default has been determined on the basis of this criterion should the information be disseminated in the group of institutions so as to ensure a group-wide identification of default.

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II. Specific comments

Q1: 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 possible reasons for technical defaults is a sensible way to neutralize unwarranted defaults classifications in the data history and is thus in principle appropriate. However, we are surprised that the consultation paper does not define the threshold stated in Article 178(2)(d) CRR for the 90 days past due criterion beyond which an obligor is to be classified as defaulting. We assume that this will be defined at a later point in time (see also draft RTS on materiality threshold of credit obligation past due of 31.10.2014). As noted in the "explanatory text for consultation purposes", technical defaults are only to be assumed for exposures where the materiality threshold has been breached. Accordingly, a reference to that effect should be included in the text of the guidelines.

Within the EBA specifications it should be possible for institutions to define and document the reasons for technical defaults as per their pertinent procedural and technical circumstances. For example, it should be possible to classify as technical defaults those constellations in which a technical 90 days past due arises purely from incorrect credit line maintenance within the institution that resulted in discrepancies between the credit line communicated to the customer and that entered in the IT systems.

Besides the problems with the IT (para. 20 (a) draft guidelines) and with the processing of already effected payments within the institution (para. 20 (b) draft guidelines), payment delays through lateness in development-related business not related to solvency should also be included as a precondition for not having to assume default (technical default). As mentioned in the general remarks, development loans in which the risk of repayment lies solely with the on-lending institution and where the obligor can no longer comply with the development purpose and is not in a position to repay the loan can trigger discussions with the on-lending institution that cannot be settled within 90 days. Were the cumulative overdue exposures to breach the materiality threshold in such a situation, the development bank would have to assume a default, even though the on-lending institution is solvent. In our opinion, this case should be included in the list of exceptions in para. 20.

Moreover, from the German perspective there is already a legal obligation to promptly correct technical defaults. Under the Federal Data Protection Act it is not permitted to store personal data without a reason and to report them, for example, to a supervisory body.

The expression "manual errors of standardized process" should be drafted more broadly. Constellations can arise in which customers are recorded as having defaulted, even though this does not involve a default within the meaning of the CRR or the guidelines, e.g. in the case of ongoing litigation.

As a step towards cross-institutional harmonization of the default definition we support the proposal for a uniform definition of the term technical default. We would prefer Option c "result of certain errors or inefficiencies in data, IT systems or processes" for the definition of technical default. This classifies those defaults which have arisen due to technical problems, procedural delays or human shortcomings in the standard process.

When implementing the proposed definition of technical defaults, it should be borne in mind that individual institutions could be confronted with considerable IT and procedural implementation costs. Since technical defaults may be due to a wide range of reasons, automatic identification is only possible

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for individual but not every conceivable constellation. Furthermore, technical identification could result in an undesirable change in default status. For example, after the occurrence of the default event, it has to be established whether the customer rendered payments which were not taken into consideration in time. In that case the default event has to be reset manually after the review. The resulting high effort is, in our opinion, unjustified in view the low materiality of technical defaults. Even though the proportion of technical defaults is low, all the defaults would, nevertheless, have to be analyzed.

Therefore, the (non-) consideration of technical defaults should be left as an option at the discretion of financial institutions.

In addition, technical defaults can arise in syndicated financing. This can arise for example where there is a delay in passing payments between the syndicate members involved or if the institution restructures the loans without default (crisis-related restructuring). This can arise, for example, if the internal limit has already been increased, but the agreement in the lender consortium cannot be achieved within 90 days. Where the obligor is not in financial difficulties, there should be no obligation in such and comparable cases to determine default. This should be added to the list of exceptions in para. 20 of the draft guidelines.

Furthermore, the interpretation of the past due criterion to determine default should state how ongoing litigation with customers over individual exposures is to be treated in the past due computation or whether this can be classified as a technical default (example: In a derivatives transaction the counterparty has a different opinion on the size of the payment due than the institution). There are also comparable constellations in leasing business, where there can be differences of opinion and need for clarification concerning the desired specification, ascertained defects or when resorting to certain performances in conjunction with lease agreements. In practice, litigation is generally avoided as the goal is to achieve an amicable solution with the lessee as customer. But finding a solution which is acceptable to both the lessee and the leasing company is often protracted. By the time the matter is clarified, such payments are then past due and can trigger a default because of the higher 90 days past due criterion.

Another technical default because of procedural aspects is quite frequently to be found in vehicle leasing to corporate lessees with a large number of leases (fleet leasing), especially if the lease payments are due on different dates. SME and large companies are often averse to granting direct debit authorizations for the lease payments so that they can manage the liquidity outflow themselves. These lessees instead receive an invoice which they have to pay. There is typically a lag between invoicing and settlement of the invoice. If a new invoice that arises from a different lease agreement is issued within that period, the due payments from those lease agreements overlap. Such overlaps arise from mail delivery periods and processing times (checking and releasing the invoice by the fleet manager, posting in the accounts payable department and the payment department triggering the payment). In many cases, further servicing and maintenance performances are rendered under full-service lease agreements which may need clarification. There may also be a need for clarification when the lessee has ordered a vehicle with specifications which turn out not to meet its wishes. Drivers of leased company vehicles can often choose additional features which are not covered by the standard lease agreement and are ultimately paid by that driver via salary deductions (lease splitting). Then it has to be clarified which services have to be paid for by the lessee and which by the driver. In cases of this nature, the full lease installment including other services rendered is normally paid only after the matter has been clarified with the leasing company. Where a lessee has a large number of lease agreements (fleet leasing), this can lead to a residue of overdue payments. If that residue of formally overdue exposures persists for more than 90 days, the special algorithm renders the lessee as formally more than 90 day past due and thus formally in default, even if the lessee's creditworthiness gives no cause for concern and no open invoice is more than 60 days old. Inclusion of such defaults impairs the validity of the rating systems at those leasing companies which are part of the regulatory scope of consolidation. It should therefore be possible for such past dues arising from particular procedural aspects in leasing business to be treated as technical defaults as well.

Q2: Do you consider the requirements on the treatment of factoring arrangements as appropriate and sufficiently clear? If not, please provide proposals for additional clarifications.

Our understanding of the requirements is that in the case of genuine factoring, i.e. the factor takes on the complete third party credit risk, the factor's capitalized exposures against the third-party obligor are treated for default recognition just like purchased exposures pursuant to CRR. In the case of non-genuine factoring, i.e. the factor's customer retains the credit risk, the entire factoring exposure vis-à-vis the customer (the total of the amounts of not yet settled exposures but still disbursed to the customer in advance) plus other accounting exposures to the same customer is included as the basis for determining the 90-day past due materiality. The total of the overdue factoring and other exposures against the customer constitutes the total exposures against the customer that are past due. If only a part of the third party credit risk is to be borne by the customer and the balance is borne by the factor, this requirement follows the accounting treatment: if the exposure is accounted for as an exposure to the customer, treatment is analogue to non-genuine factoring.

This orientation on the accounting treatment could result in deviations from the economic management of the factoring company. In the actual default determination in factoring business, especially for genuine factoring, it must be possible to permit reclassification of defaults detected at the third-party obligor if, for example, the verity of the exposures was not established and this is caused, for example, through fraud on the part of the customer or a defense on the part of the third party obligor upon the customer's insolvency. Furthermore, the third party obligor's defense can also lead to payment delays if there are not sufficient reserves which should in effect be assigned to the customer.

Q3: Do you agree with the approach proposed for the treatment of specific credit risk adjustments?

In principle, harmonization between accounting standard requirements and supervisory default recognition is desirable, because this promotes uniformity and efficiency in reporting, bank management etc. For IFRS-accounting institutions for example this is also in line with the BCBS's thoughts (BCBS 350 "Guidance on accounting for expected credit losses"). The synchronization of triggers for individual valuation adjustments pursuant to IFRS or US-GAAP with the CRR default definition frequently encountered in practice already reflects this. Likewise, the – in our opinion effected – exclusion of not yet incurred losses from the default recognition is reasonable given that there is here no indication yet of an actual default event.

The individual impairment adjustment (e.g. SLLP and PLLP impaired) is an established criterion for determining defaulted customers. For that reason, we welcome the envisaged standardization of interpreting the formation of an individual impairment adjustment in principle as a default. Important in this context is that general individual valuation adjustments or value adjustments without any consideration of a specific case never serve as the basis for default. It would be disastrous in our opinion, were for example GLLP or PLLP non-impaired to be understood as default criteria and this misunderstanding lead to typical Stage 1 or Stage 2 exposures being given an IFRS 9 Stage 3 classification.

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It should also be made clear that exposures classified as Stage 2 under IFRS 9 and for which correspondingly increased SCRA have to be formed need not be classified as defaulted. Likewise, we see a need to point out that where payment delays have not yet occurred, country risk provisioning may not be taken as an indicator for the insolvency of a particular obligor, either.

For exposures recognized at fair value and whose value changes are taken to the income statement, we consider it to be inappropriate that impairment alone results in default. On the one hand, in principle only the credit-risk induced portion of an impairment would be relevant. On the other hand, there is also the question from what amount a credit-risk induced impairment is to constitute a default event. In contrast to exposures measured at amortized costs, this would suddenly introduce a relative default criterion with analogies to Stage 2 in accordance with IFRS 9. For example, the situation could arise in which an exposure to an obligor who had been given a very good rating when the loan was granted and only has an average rating now as of the accounting reference date only is classified as defaulted due to present-value credit-risk induced losses, even though – were the exposure to have been accounted for at amortized costs – this is nowhere near Stage 3 in accordance with IFRS 9 or a default and for whom a portfolio value adjustment taken to the income statement may already have been effected on the basis of the same parameters as for the fair-value calculation (e.g. for Stage 3 portfolios).

As a rule, banks have harmonized their default definitions for both at-cost and fair value accounted transactions. Thus, the default triggers which lead to a Stage 3 classification in lending business are also largely applicable for fair value exposures. A book-value adjustment of fair value exposures is not necessarily an indication of obligor default. The book value may have to be adjusted, e.g. in the case of securities, solely to a minor deterioration in the issuer's rating, without the issuer itself necessarily having experienced economic difficulties and thus not likely to default.

We would like to point out that bonds of less creditworthy countries would be especially affected by this extended default definition. The credit ratings and credit spreads of countries with a lower grade credit standing have been very volatile over the past few years because of the market circumstances. Even minor downgradings in the investment grade range have impacted securities prices significantly. The proposed definition creates a risk that institutions would have to classify a large proportion of less creditworthy countries as defaulted.

Therefore, as an alternative we suggest the approach devised by the German regulatory body in liaison with the German banking industry and applied for a number of years already. Under this approach, a value adjustment on securities due to only a low downgrading of the issuer is not classified as default. A not low value adjustment/partial write-down is to be assumed, in so far as a security is impaired or written off by at least 50% of its book value within one year for credit-risk reasons. If the credit-risk related impairment or value adjustment cannot be determined separately, the value adjustment or impairment altogether can be applied as an alternative.

According to the proposals of the draft guidelines exposures are to be classed as defaulted if classified as Stage 3 in accordance with IFRS 9. Here, we would point out that this provision could lead to problems in the granting of development loans. As mentioned in the general remarks, the development bank and on-lending commercial bank frequently share the risk of a development loan. The development bank has two risk positions in that case: one against the borrower and one against the on-lending institution. However, under IFRS 9 classification as Stage 3 must be carried out uniformly on the basis of the financial instrument – i.e. for the loan. If the final borrower defaults, then the development bank would have to classify the entire loan as Stage 3, even though the on-lending institution is still solvent. In our opinion, this case should be included in the list of exceptions in para. 28 of the draft guidelines, so that the development bank only has to treat the exposure to the borrower as defaulted.

Q4: Do you consider the proposed treatment of the sale of credit obligations appropriate for the purpose of identification of default?

Under the EBA proposal a default is to be assumed, if the loss on the sale of a credit obligation exceeds a certain threshold set by the institution. The EBA suggests a 5% cap for that threshold (para. 33 of the draft guidelines). We cannot accept such a fixed relative, deterministic default trigger based on a not economically certain loss: besides the misclassification of affected borrowers with retained exposures such a threshold can lead to significant distortions in the time series used for internal rating systems. The criterion "the institution sells the obligation exposure with a material credit-related economic loss" can in the specification suggested in the consultation paper at best serve as a possible indication which requires underpinning by further indications. Without doubt, certain very high economically correct credit-induced price mark-downs also have a very much greater predictive value. Price mark-downs of, say, 5% are on the other hand practically irrelevant for identifying default as such, because even minor creditworthiness changes especially in longer term positions can lead to such value changes.

Should the EBA nevertheless set a cap for the threshold, despite our petitum, serious thought should be given to the level. In our opinion, this general threshold is too low. A selling price below 95% can come about very quickly, e.g. for long-term, low-interest assets, if the counterparty default risks cannot be estimated precisely by the contractual partner. However, this does make it a criterion for default (see also response to question no. 6). We would therefore argue for a threshold of at least 50%.

We understand the formula in para. 33 of the draft guidelines to mean that the starting point is the outstanding amount of the obligation with accrued interest and fees. As mentioned in the general remarks, the difference between “the total outstanding amount of the obligation subject to the sale including interest and fees” (E) and the selling price involves not only credit-induced aspects but also many other components which as a rule cannot be unequivocally identified. Hence, the loss here is not an economic loss, because the starting point does not represent a discounted value but comprises only the outstanding amount of the obligation with accrued interest and fees. Thus, even a long-term fixed-rate agreement below the prevailing market rate for the exposure to be sold, for example, would normally lead to a present value mark-down and thus to a reduced selling price of less than E, without the current creditworthiness having necessarily deteriorated compared with that when the loan was granted.

A present value assessment, on the other hand, even for IFRS or US-GAAP accounting institutions is not proportionate to the benefit, because there are no present values calculated for the balance sheet for exposures carried at amortized cost, for example. And even if the PV-related loss and only the credit-risk-induced part could be determined, this would result in a similar issue as in question 3 in the context of fair value losses ('relative default criterion'). Thus there is logically a risk that borrowers still of sound creditworthiness would also be classified as defaulted. This too leads to pronounced distortions in the explanatory features in the development of rating models, for example, and consequently to rating systems developed on the basis of those data having a poor predictive power.

According to the consultation paper, in the case of portfolio sales with a collectively determined purchase price, all borrowers in the portfolio are to be considered defaulted, if the collective loss or purchase price discount is below the to be defined threshold. Besides the considerable reservations expressed above, there is also a risk that numerous borrowers in a portfolio of heterogeneous credit ratings would be considered defaulted, even though individually they have not suffered any value loss at all. This leads to additional distortions in the historical time series and to further current misclassifications of affected borrowers from which exposures have been retained.

Furthermore, we plead for a clear distinction from exposures sold for non-credit risk related reasons and hence should not be taken as an indicator for imminent default. For example, the merger of two institutions leads to a concentration risk for certain exposures. Therefore the institution sells a part of the exposure for reasons that are not credit-related. Under the draft guidelines and Article 178 (3) lit. c) CRR a default would nevertheless have to be recorded, even though the sale was motivated not by credit-related (deterioration of the exposure quality) but other reasons. Recording a default is in our opinion not justified. Clearer distinction of this constellation would be appropriate.

Q5: 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?

If the institution waives money as part of a credit obligation restructuring by reducing or postponing the exposure, the interest or fees, then the exposure is to be classified defaulted, if the exposure has to be considered as "forborne" as part of the ITS for forbearance and non-performing loans and the obligor's financial obligation has been reduced by a certain material amount. The EBA would like to base the determination of the reduced amount on a comparison of the present values of the expected payment flows.

The threshold for the reduction of the financial exposure is in principle to be defined by the institutions themselves, albeit as long as a cap of 1% is not exceeded.

We reject the determination of the reduced exposure by means of comparing the present values of the expected payment flows. Ascertaining present value differences would cause institutions a considerable amount of additional work and deliver at best a limited regulatory benefit. Even IFRS accounting institutions have so far not been expected to carry out present value comparisons before and after modification in every case. Accordingly many institutions would have to carry out IT-specific implementations. We therefore suggest that the nominal values be used.

Regardless of our objection to a present value comparison, the 1% cap suggested by the EBA strikes us as far too low. Applying this value could lead to a large number new defaults, which would then return to a non-defaulted status relatively quickly. During a restructuring, an attempt is made to boost the debtor's loan servicing capacity so as to avoid a default. Depending on how the loan agreement is modified, there could be a present value reduction that exceeds the suggested threshold. Should the EBA insist on a comparison of the present values of future expected payment flows, despite our petitum, the threshold should in our opinion be at least 10%.

Moreover, the described approach as we understand it would mean that all pure restructuring measures carried out at the original effective interest rate (pure forbearance measures without interest waiver) do not in principle lead to a default, because the present value of the discounted cash flows does not change. The final guidelines should make it clear that forbearance measures involving principal repayments, fees or interest (with interest capitalization) do not require an individual present value assessment.

The exact definition of the terms "large lump sum", "irregular repayment schedule" or "significant grace period" as per para 42 of the draft guidelines is left as we understand it to the institutions themselves.

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However, it should be made appropriately clear that the definition is to be specified by the institutions. Furthermore, these indications should not automatically lead to default, because the aforementioned agreements between the institution and the borrower are made on the assumption that the borrower is to be put in a position to service its loans in their entirety.

We assume that "customer's effective interest rate" means a credit-based computation and a customer average is not to be determined.

For all IFRS 9 accounting institutions, using the original effective interest rate for discounting the cash flows before and after the restructuring is desirable, because this would harmonize with the IFRS 9 requirements. Accordingly, we in principle support the current proposal. However, using a lower relative threshold D_0 compared to IFRS 9 would mean that all the financial instruments written off and reposted due to the present value comparison under IFRS 9 would automatically be considered defaulted, something that we consider to be completely unwarranted. This is in part due to the fact that the difference D_0 includes the accounting present values of a large number of effects which are not solely related to the credit risk and hence tend to be larger than the credit risk-induced loss in value.

Institutions not accounting as per IFRS, i.e. the majority of the affected institutions, do not have any implementation of the present value comparison by dint of their accounting requirements, so that the technical implementation of this requirement would involve a considerable amount of effort. Furthermore, determining an effective interest rate constitutes a not inconsiderable challenge even for IFRS accounting institutions. For that reason, financial institutions which do not apply an effective interest rate under the accounting standards relevant for them should be given an opportunity to use other discounting rates in line with the institutions' economic management instead of the effective interest rate.

The approach suggested leads to a considerable technical workload without actually measuring the desired credit risk-induced effects. The intended synergy effects between IFRS 9 and regulatory requirements are in principle welcomed but are relevant for only a handful of institutions, however. Nor should it be overlooked that IFRS 9 only governs the potential restatement in the balance sheet via the change in present value and does not aim at measuring credit risk-induced value changes. In view of these striking limitations, here too a default can be deduced with a high degree of probability only for very significant drops in present values D_0 (e.g. 50%). Minimal drops in present values, such as 1% or 5%, are unsuitable for this due to the aforementioned limitations and could at best be used in conjunction with other relevant indicators (analogue to the approach in para. 42 of the draft guidelines).

Institutions are also to classify all "forborne non-performing exposures" as defaults. The reference in the draft guidelines to Annex V of ITS 2014/680/EU for the definition of "forborne non-performing exposures" should be made more precise: it is unclear whether the definition refers solely to para. 180 Annex V of ITS 2014/680/EU or whether additional criteria, such as the present value review in para. 40 of the draft guidelines, also have to be taken into consideration.

Q6: Do you agree that the purchase or origination of a financial asset at a material discount should be treated as an indication of unlikeliness to pay?

We do not agree. Due to market price fluctuations (which admittedly reflect an increased default risk, but still well short of "unlikeliness to pay"), assets can be bought on the capital market well below their issue price. For example, assets with a constant good to average rating might be traded at prices well below 90%. Such a discount can have any number of reasons and need not necessarily suggest that the issuer

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has defaulted. Likewise, as with question 4 a non-present value assessment would lead to an additional distortion in this assessment and here too introduce a relative default threshold.

For that reason, a purchase price discount should lead at most to a review of creditworthiness, but not necessarily to a default. A considerable purchase price discount of, say, 50% could well be seen as a high probability of an actual default.

In general, a distinction should be made between market price fluctuations arising from general market interest rate changes without any rating changes (general interest rate risks) and specific credit-rating related market interest rate changes (particular interest rate risks). Market price fluctuations because of general market interest rate changes should not be able to trigger a default.

The distinction can, in our opinion, be made on the basis of the definitions used in determining the minimum capital requirements for market risks.

Furthermore, it should be noted that this is not fully analogous to IFRS 9, because a purchase price discount does not necessarily lead to an impairment and thus does not necessarily lead to a "purchased or originated credit-impaired" (POCI), either.

As an additional remark about "Other indications of unlikeliness to pay", we would like to point out that upon corresponding interpretation the requirement in para. 48 of the draft guidelines to use external data sources for default recognition would lead to a high technical and procedural workload in retail business that would not be in proportion to the expected benefit, in our opinion.

Besides the default definitions in Article 178 CRR it is from our perspective a good idea to define further indications of a possible default. The many indications of unlikeliness to pay should however only be regarded as possible indicators for unlikeliness to pay, on the basis of which a more thorough examination then has to be carried out into whether there is actually default.

In this context we also have doubts about the requirement that external databases should be used as sources for such indications. This process seems very laborious for institutions – in particular those applying a pool approach for their risk measurement method – and would tie up a great deal of resources within the institution. In addition, it can be difficult to verify the credibility of these data sources, which would tie up even more resources within the institution.

For the draft guidelines, attention should be focused on keeping the research workload for institutions as low as possible.

Furthermore, the EBA proposes that macroeconomic indicators should be taken into consideration when determining defaults. Counterparties with a weak position in a sector affected by a crisis could be directly considered as defaulted (para. 48 (b) of the draft guidelines). It is no doubt widely accepted that such companies are exposed to a considerably higher default risk. This would probably call for intensive care treatment. However, we do not favor an indication as default, because such an indication would aggravate the crisis. Under IFRS 9 such companies would have to be classified as stage 2. Only if it becomes actually unlikely that the obligor will be able to meet payment obligations without recourse to collateral should a default indication be assumed.

Development banks frequently invest in industries and countries facing an economic crisis. In most cases, state-owned banks are even instructed to intensify such promotional activity in order to support particular sectors and promote economic recovery. The suggested provision would be a considerable handicap to such development policy measures.

Q7: 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 introduction of a probation period is inter alia meant to reduce the number of multiple defaults and thus at the same time reduces the scope arising from modeling alternatives for multiple defaults as part of the PD and the LGD. For that reason, applying a probation period is in our opinion meaningful and reflects actual practice.

This is the case especially in the restructuring of non-performing exposures. Here the suggested one-year probation period is in principle plausible, because this is in line with the probation period under the regulatory reporting system for forborne and non-performing loans. However, we would prefer to see a distinction made between asset classes. Such a differentiation in the form of an option of the institution would be advisable for retail business. In retail business the high degree of process automation should be sufficiently taken into account and cost-intensive manual assessment processes be dispensed with. Any additional process requirements should therefore be formulated such that these can be applied algorithmically and automatically. This means it must also be possible to automatically restore positions to non-default status without having to trigger an individual restoration process including individual documentation. This option should be applicable for restructuring and all other retail exposures.

Apart from restructuring, we consider the specification of fixed minimum periods for a return to non-default status to be inappropriate. Institutions should be able to choose those tried-and-trusted periods from their individual internal risk management.

This approach also strikes us as reasonable given that para. 64 of the draft guidelines in any case requires institutions to analyze the change in obligor status between default- and non-default and use the outcome of that analysis to individually specify longer periods than the minimum periods, where appropriate.

Furthermore, we also consider the fixed specification of minimum periods to be inappropriate because there must always be a possibility of an immediate return to non-default status, if an obligor's rating situation is promptly and lastingly restored to a sound footing, e.g. upon receiving a large payment that enables the obligor to completely repay the overdue installments. Where such obligors are unnecessarily defaulted, this can lead to process problems, if they intend to take out new loans or conclude lease agreements. Lending to defaulted borrowers and lessees is usually not envisaged in banking practice and in line with institutions' risk strategy. Hence, granting a loan or concluding a lease agreement is not possible under the institution's process parameters for obligors in default status. Customers who have put their payment problems behind them should therefore not be unnecessarily excluded from a loan or a lease agreement, because this can possibly considerably aggravate the liquidity situation of such companies and in a worst case scenario lead to insolvency. Against that background, in general a probation period should not be applied for terminations and payment delays of more than 90 days, if the borrower or lessee has settled the overdue installments.

A probation period must definitely not be applied if the default is not credit risk-induced. This should also be the case for lessees who are more than 90 days past due because of the particular aspects in leasing business (see our answer to question 1) and the specific algorithm of the default day metric but whose solvency is beyond any doubt and none of their payments are open for more than 60 days from invoicing.

After all, the statutory insolvency procedures also define the duration of the phase up to conclusion of the insolvency process (known as the probationary period in personal insolvency). After that process ends, immediate return to non-default status should be possible, so that these obligors can have normal access to banking transactions and the provisions on banking solvency do not prolong the period of default status and thus delay participation in normal banking activities.

The EBA's proposal that defaulted exposures be reclassified as non-defaulted only after a three-month probationary period confronts development banks in particular with considerable problems: As mentioned in our general comments, sometimes a borrower of a development loan ceases to meet the criteria under which the loan was granted and is moreover unable to repay the loan. In cases of that nature, a dispute can arise between the development bank and on-lending institution over the question whether the criteria for the development loan are met or not. If then the on-lending institution is considered "defaulted", something that we oppose, the institution might be considered as non-defaulted again only after a 3-month probationary period.

There is also the aggravating factor that quite often due to the many exposures granted via the one institution, not all of the development bank's exposures to that on-lending institution are repaid. In that case, the exposures to the institution could also be considered "restructured". This would mean that the probationary period is prolonged to one year. We would therefore argue that a return to non-default status should be possible immediately and without a probationary period, if the default cannot be attributed to the debtor's creditworthiness problems.

Q8: Do you agree with the proposed approach as regards the level of application of the definition of default for retail exposures?

In principle, we agree with the proposed approach. This applies especially for the mapping of internal risk management practice. Larger groups of institutions with sub-groups which use specific business models sometimes apply different levels for one and the same customer group. Sub-groups which look to build a house banking relationship with the customer and those specializing in offering specific products, such as consumer loans, mortgages, asset leases and suchlike generally take different approaches.

Switching in such cases would involve an immense technical and expert workload. On the one hand, for example, the entire default recognition process would have to be revised and adjusted. On the other hand, migrating the application level would entail a complete new development and implementation of a large number of rating systems. Moreover, the term "strict minimum" needs further specification, before a definitive opinion on the requirement can be expressed. Analogue to the comments made concerning section 9 of the draft guidelines, "strict minimum" should be specified such that sub-groups whose business models, like those of their competitors, are based on the contract level are not forced into having to determine a differing default definition at the customer level.

Q9: Do you consider that where the obligor is defaulted on a significant part of its exposures this indicates the unlikeliness to pay of the remaining credit obligations of this obligor?

Under Art. 178 subparagraph 2 CRR, institutions have an option for retail-business risk positions to measure default at the loan agreement level and not – as mandatory for all other risk exposures – at the obligor level. From our perspective, using a "pulling effect" in retail business contradicts the underlying thoughts of measurement at the contract level. For example, introducing such a mechanism for measuring default risk (depending on the selected threshold) implies de facto measurement at the obligor level, because given sufficient volume default of a particular exposure to a customer entails default of the remaining exposure. Introducing a "pulling effect" would hence sharply restrict the possibility of measurement at the contract level.

Nor is a pulling effect justified if the customer behaves completely differently depending on the type of financing contract. For example, as a rule customers with vehicle financing are very keen to meet their payment obligations because they depend on those vehicles. The same customers behave completely differently when it comes to repaying an unsecured direct bank loan granted online. A pulling effect mechanistically implies that defaulting on the direct bank loan granted online will also lead to defaulting on the vehicle financing. But as practice shows, the payment behavior relating to an unsecured direct loan is a very poor indicator for payment behavior concerning vehicle financing, for example.

Moreover, technical implementation of the "pulling effect" is complex, because the default flag for the one contract has to be determined in the light of the default flags of all the other contracts held by the same obligor. Consequently the default flags for all the contracts have to be reviewed together. For that reason, the "pulling effect" contradicts the original intention of simplifying the implementation for measuring default events at the contract level.

In particular in view of the fact that some institutions in retail business have designed their business model and their internal risk management at the contract level, we consider the "pulling effect" to be inappropriate, because this de facto forces default measurement at the customer level, which is functionally not reasonable for such cases, delivers no added value and causes considerable implementation costs.

Q10: Do you agree with the approach proposed for the application of materiality threshold to joint credit obligations?

The proposed approach requires considerable effort for its implementation, because default recognition depends on upstream determination of the default event for joint credit obligations. This forms the basis for determining a default event of all individual exposures to the obligors participating in the joint credit obligations. This requires linking the joint credit obligations and the individual credit obligations. However, establishing this link involves a considerable amount of expense for many institutions.

Furthermore, the proposed approach leads to an increase in default recognition, because all the joint credit obligations lead to a default cascade to the credit obligations of the obligors of the joint credit obligation, independently of the payment behavior of the obligors for their individual credit obligations. This tends to lead to an unjustified increase in defaults, because obligors which meet all the payment obligations under their individual contracts are also classified as defaulting. Moreover, for obligors with very low joint exposures, but high individual exposures, the materiality threshold for their individual default measurement falls significantly.

Likewise, here too it is unclear how the number of defaults has to be determined. For example, it has yet to be specified whether the default of a joint credit obligation is one default or as many defaults as there are obligors in the joint credit obligation. As a third alternative the number of defaults can be computed as the number of obligors plus the number of joint credit obligations.

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Again the question arises as to how a defaulted "synthetic" obligor comprising the joint and several liability of individual obligors is to be handled in the default time series for developing and validating rating models. Due to the vague assignment of variables yet to be clarified, the only viable solution boils down to excluding that data record in this context.

Due to the difficulties of the proposed approach stated above, the treatment of joint credit obligations as independent obligor is preferred. This counts all the joint credit obligations with the same set of obligors as one obligor. On the one hand, this takes the risk character of joint credit obligations and the individual obligors adequately into consideration in the default recognition. On the other hand, the "unlikelihood of payment" enables a default cascade from the joint credit obligation to the individual obligors, should this be considered justified.

Automatic default cascade is not regarded as reasonable. If the obligors in a joint credit obligation have differences of opinion concerning the repayment of an exposure (possible with mortgages in particular), a default event can arise. This does not necessarily affect the obligations taken on by the obligors individually. The draft guidelines also indirectly follow this perspective in para. 89 ("A joint obligor, i.e. a specific set of individual obligors that have a joint obligation towards an institution, should be treated as a different obligor from each of the individual obligors."). If a separate obligor is to be created for joint credit obligations, then it makes more sense to also consider them separately during default determination.

Therefore, when an obligor for which a joint credit obligation has been created defaults, reviewing the default cascade to the individual parties makes better sense than an automatic default cascade.

The economic idea behind the requirement of also defaulting the synthetic obligor of a joint credit obligation when all the individual obligors default is appreciated. Nevertheless, we consider the technical implementation of default recognition and especially the return to non-defaulted status to be very laborious and therefore favor the treatment of joint credit obligations as independent obligor and thus the implementation of a technically less complex solution.

The group-wide calculation method specified in the draft guidelines concerning the materiality threshold for 90 days past due would require a real-time group-wide data repository for all exposures. The effort for implementing a technical solution is enormous. The overlap of portfolios within several subsidiary/parent companies is quite often low, however. The implementation effort thus exceeds the benefit, in our opinion. Therefore, where the default definition is applied in a group of institutions it should be possible to carry out the computations for the materiality threshold for 90 days past due at the individual institution level. Only after a default has been determined on the basis of this criterion should the information be disseminated in the group of institutions so as to ensure a group-wide identification of default.

Q11: Do you agree with the requirements on internal governance for banks that use the IRB Approach?

Due to the relevance of a uniform and clearly defined default recognition for the development of IRB-compliant rating systems (PD, LGD and CCF) and hence for the measurement of the required minimum capital requirement as well, we regard the involvement of senior management and the management body in the specification of the default definition at banks using the IRB approach to be necessary. We consider a review of the default definition and ongoing procedural default recognition by the internal auditing department to be meaningful.