

BBA response to European Banking Authority's consultation on draft regulatory technical standards on materiality threshold of credit obligation past due

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*Introduction*

The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking enabling us to represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world's leading financial and professional services organisations. Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

When implemented these proposed regulatory technical standards (RTS) will have a significant impact on those of our members who use IRB modelling approaches to the calculation of Risk Weighted Assets (RWA), both in terms of operational compliance but also, initially, in how they communicate RWA changes to the investment community. We are therefore pleased to respond to the EBA's consultation on its draft RTS on a materiality threshold for credit obligations past due<sup>1</sup> on their behalf.

Before responding to the EBA's specific questions we highlight below some more general comments.

*Implementation will be time and resource consuming for the industry and supervisor alike*

We support the underlying principle of RWA comparability to which the draft technical standards are seeking to contribute by harmonising approaches to establishing a materiality threshold. In doing so however the proposals have the potential to require banks to undertake significant revisions to their internal models and for supervisors to review and approve these changes.

The requirements that a bank must meet in order for its ratings systems to be used for the calculation of Risk Weighted Assets for regulatory purposes are necessarily and rightly comprehensive. In particular banks must demonstrate that they have input data allowing them to calculate PD, LGD and EaD over a sufficiently long period of time which encompasses both good and bad economic conditions. As the EBA is aware, depending on the category of borrower and transaction characteristics, minimum data observation periods are required of between five and seven years. We recognise that an extended transition period would not be feasible but nonetheless encourage the EBA to discuss with competent authorities what is a 'reasonably limited' transitional

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<sup>1</sup> <https://www.eba.europa.eu/documents/10180/878549/EBA-CP-2014-32+%28CP+on+RTS+on+Past+Due+Materiality+Threshold%29.pdf>

period. We envisage this as being no less than two years and that it should be subject to bilateral agreement between the individual bank and its supervisor. However we note in our response to question 3 that a much more preferable approach would be to incorporate this proposed change into the rule book at the same time as any changes to the definition of default which we believe the EBA is considering too. Contemporaneous implementation of two closely related aspects of risk modelling is much to be preferred.

*Harmonisation is helpful but should establish upper bounds not absolute limits*

We agree with the EBA that harmonisation of approaches to the setting of thresholds by competent authorities is helpful for banks operating across borders but do not see this as an initiative that is designed to introduce a single pan-european limit, nor should it be. The purpose of the RTS is to establish a methodology that individual competent authorities should use when setting a materiality threshold rather than establish a one size fits all approach would be of little merit given the disparate nature of bank lending in the EU. So we support the EBA's approach but believe it will require significant changes to banks' systems.

For this reason we suggest, as we believe the EBA's proposals already recognise, that the two thresholds should be viewed as a maximum requirement both at a jurisdictional level but also at the level of the individual banks. This implies that where a bank already uses a more conservative absolute threshold it should continue to be allowed to do so. Maintaining this status quo for those banks with a more conservative approach to materiality thresholds would greatly assist members in their implementation planning and would not, in our view introduce extra risk into the European banking system.

*At facility level or across the all the borrower's credit obligations*

It is not clear to us how the limits will be tested, against the aggregate of a corporate borrower's facilities or at the individual facility level. To avoid unhelpful cross-default situations we recommend that the test should be applied at the aggregate level for both absolute and relative test. This would require the amendment of Article 2.2. We interpret article 2.2 (b) as applying the relative test to the aggregate of all a borrower's credit obligations whereas the application of the absolute test in 2.2 (a) is less clear. It would also be helpful to have a clearer view of what constitutes a credit obligation - how should, for instance, off balance sheet items and leasing obligations be treated?

It would also be helpful to have a clearer definition of the number of days past due and we suggest the following change to Article 2.2a:

- a) the absolute component of the threshold shall be set as a limit to the sum of all amounts that are in excess of more than 90 days or 180 days past due where the competent authority has replaced the 90 days with 180 days in accordance with Article 178(1)(b) of Regulation (EU) No 575/2013 related to the credit obligations of the borrower to the institution, the parent undertaking or any of its subsidiaries ('credit obligation past due');

## Response to Questions

- Q1. Do you agree with the approach proposed in the draft RTS (option 1) that default should be recognized as soon as one of the components of the threshold (absolute or relative limit) is breached? Or would you rather support the alternative option, i.e. recognition of default after both thresholds are breached (option 2)?

The preference of the majority of our members is that default should be recognised once both components of the threshold have been breached. We recommend that the absolute limit is also balanced by a relative one. This will minimise the chance of false positive technical breaches as our expectation is that an absolute limit breach will be the triggered more frequently than the relative one.

However the technical standard should enable individual competent authorities to permit banks to continue to employ the absolute threshold only, or where this is aligned with their current business practice, lower thresholds in order to prevent unnecessary model changes which would require supervisory approval.

We therefore recommend altering the text of Article 2.2 (c) as follows:

(c) where ~~either or~~ both of the limits referred to in points (a) and (b) is breached, the credit obligation past due shall be considered material, and the obligor shall be considered defaulted. Competent authorities may permit institutions to employ either of the limits, or establish them for their own purposes at a lower level, where doing so would not result in fewer past due obligations being classified as material.

This is recommended on the basis that both the absolute and relative thresholds set by the competent authorities are maximum ones – see our response to question 2.

- Q2. Do you agree with the proposed maximum levels of the thresholds?

We support the €200 for retail and €500 for corporate absolute thresholds but wonder however whether it would be helpful if there were different percentage relative thresholds for corporate and retail exposures to reflect different market specificities. For instance retail exposures, and SME exposures managed as retail on a portfolio basis, could be subject to a nationally set relative threshold whereas larger corporates would be subject to a higher percentage limit which would be set at the same level across all EU jurisdictions.

Where banks are already using more conservative absolute and relative thresholds they should continue to be allowed to do so. This approach recognises that portfolios and the ways of managing portfolios are different and banks should therefore have the flexibility to use different thresholds. For example, the same threshold is not considered appropriate across such different retail product types as high value mortgages and low value overdrafts. Banks should be able to adopt a more conservative approach where they consider this appropriate.

Q3. How much time is necessary to implement the threshold set by the competent authority according to this proposed draft RTS? Given current practices, what is the scope of work required to achieve compliance?

As we have noted above these proposals represent a material change to a key input into model design. It will require significant work by our member banks to recalibrate rating models and amend the IT systems and governance processes that support them. But the supervisory community which will likely have a significant number of model changes to approve will also have significant demands placed on it.

We believe that a transitional period of less than two years will prove impossible to implement and that consideration should be given to allowing competent authorities to adopt a phased approach which focuses on approving any necessary changes to more material models first, with others following to a longer time frame of up four years. This problem will be ameliorated if banks that are currently using materiality thresholds that are more prudent than those proposed should be allowed to continue doing so, without being required to migrate to the proposed thresholds.

Furthermore we understand that the EBA will soon be making proposals in relation to the Definition of Default. This is also an aspect of the Basel Committee's consultation on a revised standardised approach to credit risk. Our strong recommendation is that this suite of changes should be introduced in a harmonised and coherent manner, not in a piecemeal fashion spread over a period of time. This would put pressure on both our members and supervisors resources as we envisage multiple applications for model change approvals will be required, which would better be addressed all at once.

Q4. Do you agree with the assessment of costs and benefits of these proposed draft RTS?

The impact assessment is a commendably thorough assessment of the current landscape in Europe in relation to materiality thresholds and of the technical options that have been proposed. We note however that there is no hard assessment neither of the costs of implementing the changes proposed in the draft RTS for banks nor for the costs to supervisors of doing so, which will ultimately also be borne by banks.

Q5. What is the expected impact of these proposed draft RTS?

Our broad-brush assessment of the costs and benefits is that there will be a material cost for both banks and supervisors, a probable increase in capital and a somewhat more harmonised approach to the establishment of materiality of default thresholds, recognising that a degree of competent authority discretion will remain.

*Responsible Executive*

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