Associazione Bancaria Italiana

ABI response to EBA consultation on
Draft guidelines amending Guidelines
on the application of the definition of default
under Article 178 of Regulation (EU) No 575/2013

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Preliminary remarks

ABI welcomes the opportunity to express views on the Draft guidelines amending Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013.

The update of the Guidelines is linked to the mandate under Article 178(7) of CRR, as amended by Regulation (EU) 2024/1623 (CRR3), which mandates the European Banking Authority to review the Definition of Default guidelines EBA/GL/2016/07 ("GL DoD"), drafted by the EBA based on the mandate in Article 178(7) of Regulation (EU) No 575/2013 (CRR) as regards the treatment of debt restructuring. The CRR3 stipulates that the EBA shall update the GL DoD taking due account "of the necessity to encourage institutions to engage in proactive, preventive and meaningful debt restructuring to support obligors" and "shall duly consider the need for granting a sufficient flexibility to institutions when specifying what constitutes a diminished financial obligation […]".

While ABI views on the specific points of the EBA proposal are illustrated in the responses to the following questions, from a general perspective, ABI observes that the draft Guidelines in the EBA proposed version seem not to include changes actually conducive to the objectives set by the legislator to encourage proactive, preventive and meaningful debt restructuring.
The EBA assumes that the flexibility allowed under the current framework is sufficient and therefore no change is proposed. Noteworthy, such conclusion is not supported by any actual assessment of the costs and benefits of keeping a more conservative approach compared to any possible intervention pursuing the objectives set by the legislators, neither in terms of threats to financial stability, nor in terms of economic impact for clients.

On the contrary, in light of the CR3 mandate and based on the considerations expressed in the following, ABI believes that a change in the GL DoD with regard to the specification of what constitutes a "diminished financial obligation" is appropriate.

Answers to the questions for consultation

Question 1.
Do you believe the current guidelines result in some exposures under forbearance measures to be incorrectly classified as defaults, thus hindering proactive, preventive and meaningful restructurings given the detrimental effects that defaulted status has for the affected obligors? If so, please further specify the characteristics of the exposures, which you deem as being subject to an incorrect classification of default.

ABI believes that the current framework hinders proactive, preventive and meaningful restructurings.
The consultation paper illustrates the EBA point of view as regards the need for an update of the GL DoD. In EBA's view, the flexibility allowed under the current framework is

sufficient and therefore no change is proposed. ABI does not agree with either the assumptions or the conclusions.
As regards the flexibility embedded in the framework, it has first to be noted that, while in principle other parts of the framework leave rooms for banks' assessment of actual unlikeliness-to-pay, the reason why raising the delta NPV threshold is necessary is precisely that, in presence of a forbearance measure, the application of a strict automatic rule jeopardises such flexibility.
On top of that, the flexibility represented by the discretionary classification of an exposure as forborne appears of little use to address those instances that substantiate the mandate. Given that the CRR3 explicitly mentions that the update of the GL is intended to encourage meaningful debt restructuring, it has to be assumed that reference is made to cases where the client face or is likely to face some difficulty, and therefore the forbearance classification is appropriate. The issue at stake – which in legislators' and ABI's view would justify a change in the GL – is leaving banks some flexibility to offer support for those cases where the difficulty of the client is temporary and can be tackled with a meaningful debt restructuring that would (a) allow the debtor to avoid the consequences of a default classification and (b) increase the probability of full repayment for the bank.
Such flexibility would only leave room for bank judgement to grant a forbearance measure allowing the client to remain performing and thus avoid incurring in a default status that would hinder such possibility. The "diminished financial obligation" rule is only a limited part of a comprehensive regulatory framework on credit risk management, loan monitoring, management of forborne exposures, identification and management of non-performing exposures. Raising the delta NPV threshold would not imply any change in the remainder of the framework, thus the overall regulatory framework ensures that, if other indicators of unlikeliness to pay are present, or concerns become apparent to the bank after the concession (based on the strict monitoring that is required for forborne exposures), the classification of the obligor as defaulted would be warranted in any case. In other words, a more appropriate calibration of the "diminished financial obligation" does not waive from a classification as non-performing where appropriate, but only limits the unwanted effects of the automaticity of the rule. In cases where there is actual deterioration, there is no possibility that the default is not identified.
Importantly, flexibility as regards the default classification cannot allow to hide losses, provided that, pursuant to accounting rules, the loss is recorded in banks' P&L at the moment when the forbearance measure is granted. Also, any increased credit risk of the exposure is covered, given that the concession of a forbearance measure normally leads to a stage 2 classification and to increase the provisioning accordingly.

The consultation paper does not provide evidence or estimates of an actual threat for financial stability deriving from a possible increase in the delta NPV threshold (also considering that the number of positions that would benefit of such measure is likely limited).
On the other hand, while the impacts on clients of being classified as defaulted are acknowledged (see paragraph 34 of the Consultation paper), this aspect is not considered nor assessed in EBA conclusion that the 1% threshold is "proportionate". Certain aspects

are not even mentioned, such as the possible impact in terms of cost of credit - due to prudential rules ((EBA/GL/2020/06) requiring to reflect the cost of regulatory capital in the pricing - in particular with regard to the possible consequences of the default classification of a client on its connected clients (due to contagion effects).

Moreover, the lack of flexibility is also not in line with European legislation that regulates the preventive restructuring frameworks (Directive (EU) 2019/1023) for companies in financial difficulties that requires creditors (banks) participating in such proceedings to continue granting credit in the event of stay of enforcement actions.

All in all, ABI believes that, after a proper assessment of costs and benefits, allowing some flexibility as regards the treatment of forbearance measures should be deemed beneficial. In any case, if the EBA wanted to further reduce the risk of possible unwanted effects following to a higher threshold, the latter could be introduced with a monitoring period and a review clause in case negative effects were actually observed.

As regards the last part of the question, i.e. identification of the characteristics of the exposures most likely to result in a breach of the threshold, the main aspects affecting the delta NPV calculation are represented by the residual maturity and the effective interest rate at origination (in both cases, the higher the level, the higher the delta NPV, all other things being equal). An aspect that ABI deems important to underline is that none of these factors is connected to the severity of the financial difficulty that the client is facing (or likely to face). Allowing some flexibility by raising the threshold would address such issue by allowing banks to better factor the risk in the process.

Still with a view to the mandate, ABI also notes that, when mentioning the possibility to offer concessions remaining below the 1% threshold (see paragraph 38 of the Consultation paper), the EBA does not offer any considerations about its understanding of what the legislators mean with "proactive, preventive and meaningful debt restructuring" and whether the proposed solution can actually be considered as such. In this regard, ABI highlights that, in banks' reported experience, the 1% threshold might be too strict also to accommodate for technical issues and compliance with national laws (e.g. in Italy, a breach of the threshold can occur also in case of mere postponement of payments, due to compliance with the legal ban on compounding interest on interests - so called "anatocism").
Last but not least, it is useful to remind that Article 178 CRR defines the diminished financial obligation as a "material forgiveness, or postponement, of principal, interest or, where relevant, fees". In principle, the delta NPV threshold should therefore be assessed against a concept of "materiality".

Question 2.
Do you think that relaxing the criteria for the minimum period before returning to the non-defaulted status for defaulted forborne exposures could be an appropriate measure to

alleviate a higher burden on your institution and clients? How material would the difference be in your case between the amounts of forborne exposures classified as NPE and as defaulted if the minimum one-year probation period in the definition of default were reduced to three-months for certain forborne exposures (with change in NPV below 5% and no loss on the nominal amount)? Would that proposal create additional operational burden or practical impediments? Do you see support such proposal, and if so, for which reasons?

ABI would not support such proposal as its implementation would determine huge operational impact (due to impacts on systems and policies), even stronger for banks applying IRB approaches, which appears not outweighed by material benefits for banks and clients.

Question 3.
Do you see any alternatives other than those referred to in this section that the EBA should consider under Article 178(7) CRR to update the Guidelines and encourage institutions to engage in proactive, preventive and meaningful debt restructuring to support obligors?

ABI considers providing flexibility through a higher NPV threshold as being the best suited option to encourage institutions to engage in proactive, preventive and meaningful debt restructuring to support obligors.
Among other things, raising the threshold in paragraph 51 of the GL DoD was identified by the industry as the better option to achieve flexibility while minimising the operational impact, for at least two main reasons:

- the threshold is applied at the bottom of the process, so its change would only affect the classification the positions actually involved, while other possible changes intervening at an earlier stage of the assessment (like changes in the definition of forbearance or in the metric for the calculation of delta NPV) would affect all portfolios and imply more demanding interventions
- The GL define the threshold as a cap to the level of delta NPV that each bank shall set in its internal policies (Paragraph 51 of the GL: *Institutions should set a threshold for the diminished financial obligation that is considered to be caused by material forgiveness or postponement of principal, interest, or fees, and which should be calculated according to the following formula, and should not be higher than 1% […]*). This means that if a bank – in light of its own credit policies and local practices on forbearance measures, or for any other reasons - does not consider necessary to make use of the additional flexibility provided by a higher EBA threshold, it can simply leave the threshold unchanged in its own internal policies and no implementation will be needed.

In this regard, ABI also wishes to clarify – in case EBA considers it as an "alternative" to the option of raising to 5% - that a change in the threshold can be declined in different ways, eg considering different threshold depending on credit features (such as remaining maturity), products, clients. The possibility could be considered of taking into account such aspects, introducing a more articulated calibration of the delta NPV threshold.

Question 4. Do you use internal definitions of default and NPE that are different from each other? Which differences are these and how material are those differences? Do you have any reasons or observed practical impediment that warrants a different definition of NPE and default? If so, please provide examples where a different definition of NPE and default is appropriate.

For Italian banks, the definition of default and NPE are normally aligned and no specific case has been identified where a different definition is appropriate.

Question 5.
Would a potential lack of alignment between the default and NPE definition lead to issues in accounting in your case?

The lack of alignment between the default and NPE definition within the regulatory framework would entail complexity, operational burden and legal uncertainty, given that the two definitions have been considered so far to be equivalent. Even before the need to adapt banks' systems and policies, a legal assessment would be needed to identify in which cases reference should be made to each of the two definitions (and to adapt the policies and processes accordingly). In addition to implementation costs, the recurring burden of keeping two categories, very similar but not identical, instead of one, shall be considered.

Question 6.
Do you agree that no specific provisions should be introduced for moratoria on the grounds of the sufficient flexibility of the revised framework? In case you think the proposed alternative treatment for legislative moratoria should be included in these guidelines, do you have any evidence of the definition of default framework being too procyclical in the context of moratoria? Do you agree with the four conditions that need to be satisfied?

In ABI's view, the Guidelines should provide specific provisions for moratoria, ie general forbearance measures granted in the occasion of emergencies, such as floods or earthquakes, to help household and businesses face the consequences of such events. In these cases, financial support measures such as the postponement of loan instalments might be decided by public authorities or offered by banks to all clients in the affected areas, in order to allow them to devote all available resources to recovery and preserve as much as possible the economic fabric.

As a premise, the reference in this question to (the flexibility of the) "revised" framework is not clear, given that no change to the current framework is proposed by the EBA and no additional flexibility is provided.

In ABI's view, the flexibility of the (current) framework is not sufficient to properly address these measures, as clearly demonstrated by the fact that, at the time of the Covid pandemic, dedicated Guidelines suspending the application of the forbearance classification were needed to ensure that the automatic rule on delta NPV did not result in unduly classification of beneficiaries as defaulted.

In addition, it has to be noted that one of the main arguments that the EBA considers as ensuring flexibility to the framework, ie the possibility for the banks to adapt the terms of the forbearance to constrain the delta NPV below 1%, is not valid in case of general moratoria. Indeed, especially in case of legislative measures, it is normally not possible to adapt the terms of the concession to the exposures of each single debtor in order to avoid incurring in a breach of the threshold. Even if formally possible, it would often be unfeasible due to the need to take a swift decision on the concession for a large number of clients.
Indeed, depending on the size of the event and the number of clients involved, an immediate case by case assessment of the actual situation of each client - and if difficulties occurred that would give rise to the classification as forborne - might not be feasible.

It is also worth noting that the unwanted consequences of applying the automatic delta NPV rule in case of moratoria are not only represented by procyclicality (i.e. limiting the concession of support to obligors to avoid incurring in classification as defaulted, and therefore jeopardising the recovery) but also by the risk of inconsistent outcomes, i.e. classification of clients as defaulted or not depending on the features of the exposure (e.g. the residual maturity) rather than on actual differences in riskiness. Applying different treatments to clients in similar situations might also expose banks to reputational risk (and more generally to deterioration in the relationship with clients).

ABI therefore steadfastly support the introduction of a derogation for moratoria such that they do not lead to a reclassification under the forbearance status, as envisaged in the "alternative approach" outlined in the consultation box.

The condition identified by the EBA that the moratoria shall be accompanied by "fiscal measures" adopted by the respective Member State seems too restrictive. ABI believes a more flexible approach is appropriate. First of all, the definition might give rise to uncertainties as regards what exactly falls in scope of the definition of "fiscal measures". ABI proposes that public measures be considered eligible not only if they have a "fiscal nature but also if they provide support to borrowers in general (for example by reducing interest accrued during the moratoria or in the form of a financial contribution to their business). In the specific case of a natural disaster, it would also be necessary to consider the possibility that injured parties, who immediately benefit from the moratorium on bank loan payments, could rely on the possibility of obtaining compensation for damages from the State or private insurance companies. Secondly, it should be considered that aid is not always provided by the State but, as often happens, by local administrations or entities connected to them. Finally, it should be noted that the moratorium provided by law is normally an emergency measure (especially in the event of natural disasters or sudden market changes) that is associated with public support measures that will be granted through subsequent provisions. It is therefore not possible to condition the greater flexibility of the supervisory provisions relating to the moratorium measures ex lege on the simultaneous granting of public incentives.

ABI would also suggest including non-legislative (private) moratoria agreed between Associations of banks and of borrowers (e.g. Enterprises Association, Consumer Associations etc.), provided that all the other conditions envisaged for legislative moratoria are met.

Question 7.
Do you agree with the revised treatment of technical past due situations in relation to non-recourse factoring arrangements? And if you do not agree, what are the reasons? Do you have any comments on the clarifications of paragraphs 31 and 32 in the current GL DoD?

ABI agrees with the proposed changes - increasing the exceptional treatment of days past due at invoice level from 30 to 90 for factoring arrangements - that are intended to address an important concern raised by the industry.

Question 8.
Do you agree with the other changes to the guidelines to reflect updates from Regulation (EU) 2024/1623?

ABI agrees with the other changes proposed, aimed at ensuring alignment of the updated Guidelines with the Level 1 text.