POSITION PAPER

WSBI-ESBG response to the EBA consultation on guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013

WSBI (World Savings and Retail Banking Group)

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WSBI ESBG

Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA consultation on *guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013*.

Before answering the questions included in the consultation paper, we would like to express our concerns with regard to the timeframe for implementing these draft guidelines. They will, jointly with the RTS on the materiality thresholds of past due credit obligations (once published), have a considerable impact on IRB banks and will lead to complex technical issues which will need to be resolved in the implementation process.

Moreover, bearing in mind that the convergence between both the regulatory and the accounting treatment is needed and the IFRS 9 implementation is still in progress, an inadequate timeframe could lead to the result of having to invest a lot of money on technical developments within a short timeframe.

ESBG would like to stress that, in principle, it considers striving for the alignment of definitions as positive. At the same time, the proposed guidelines may require recalibration of a significant part of institutions' IRB portfolios, depending on the deviation between the currently-used definition and the proposed one. Furthermore, requirements to adjust historical data to the proposed application of the default definition will be difficult since adequate data may be missing.

Based on the considerations above, it is of crucial relevance to determine the deadlines for the implementation of both these draft guidelines and the RTS on the materiality of past due credit obligations, in a wise and feasible manner. More precisely, ESBG expects considerable challenges in the development of IT-systems and models. Those tasks will be costly and time-consuming for institutions as well as for competent authorities which will potentially receive numerous applications on material changes to IRB models. 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.

***Question 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.**

In Section 3.2.2 the notion of technical default is elaborated on, although the notion never was specified in the CRR. The EBA argues that the understanding and application of technical defaults varies significantly across institutions and recognises that most technical defaults should be targeted by the RTS on materiality threshold for past due exposures. However, the materiality threshold will be unable to target all situations where a technical default has occurred, in particular should this threshold be a fixed amount, and therefore the EBA includes a definition of technical default as part of the harmonisation of the definition of default.

ESBG would appreciate further clarification regarding the specification that only IT errors are to be considered as technical defaults. In fact, it seems – according to Section 3.2.2 (first bullet point on page 7) and Section 5.1.D.c (pages 50-52) – that only scenarios in which a false default could occur as a result of a bank error are contemplated, but ESBG believes that, in some circumstances, there could also be technical errors stemming from a counterpart's data system.

It is important to note that, in the modelling of larger customers, it is expected to be more common that payment delays not caused by financial issues would exceed the materiality threshold, should the materiality threshold be fixed rather than relative. If defaults that are a result of data or system errors of a counterpart are not regarded as technical defaults, the modelling of PDs for large corporates will turn into a matter of modelling probability of errors in customer's data and payment systems. The definition of a technical default should therefore also recognise cases where the default was a result of data or system errors of the counterpart.

Other technical default cases could further arise from situations in which a customer does not make the payment for reasons not directly linked to the credit. This has occasionally been observed in leasing contracts where the obligor misses a payment just because the service is no longer provided or there are failures in the equipment under the leasing contract. Other situations could stem from disputes between the contracting parties. Sometimes the bank would have knowledge of this and it could consider it reasonable to wait for the missing payments until an agreement on the dispute is reached.

***Question 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.**

ESBG believes that they are sufficiently clear.

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

ESBG is supportive of the alignment between the regulatory definition proposed by the EBA and the accounting definition under IFRS 9. In this respect, in general, we agree that when an institution treats an exposure as stage 3 under IFRS 9, such exposure should be considered defaulted. However, there are a few cases where this should not apply. A typical example would refer to those assets classified under IFRS 9 as POCI (purchased or originated credit-impaired), which under the accounting framework would be maintained always as stage 3 regardless of whether their credit quality improves or not. In this respect, the EBA could avoid that the definition of default prevents some exposures of returning to a non-defaulted status.

To be more precise, ESBG is not advocating for the same definition of default and of stage 3. In fact, we would like to emphasise the importance of not creating unjustified differences between both definitions. There are indeed aspects where differences are justified because of the different aims of the risk and accounting frameworks.

In addition to this, we would like to request a similar clarification in terms of what happens if an exposure moves from stage 1 to 2 or vice-versa under IFRS 9 and its impact on the definition of default or unlikeliness to pay. ESBG is of the opinion that classification in stage 2 should not automatically be considered as an indication of default.

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

ESBG does not believe that the sale of credit obligations is appropriate for the purpose of identifying defaults. In case the creditworthiness of a portfolio has decreased, this is caused by defaults in that portfolio (via arrears or distressed restructuring). This default recognition leads to an increase in expected loss, provisioning on portfolio level and maybe on RWAs.

The decision/intention of a financial institution to sell a credit portfolio may lead to a different valuation on the balance sheet and may have P&L consequences. Since IFRS rules may apply in this case, we see no added value to also recognise the realised loss as a default.

<u>Question 5:</u> 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?

ESBG supports the pragmatic approach to use the effective interest rate applicable before signing the restructuring agreement. That way the interest rate used for discounting would better reflect current market conditions and it is our view that this is more accurate, in particular when a long time has passed since the credit was disbursed with many changes of interest rates due to changes in the market situation. For institutions it may also be burdensome to track original effective interest rates in systems. In addition, we believe that the cash flows should be calculated at customer level.

Another alternative could be that these interest rates are optional, i.e. the lender can choose the one being most relevant in the actual case, either the original effective interest rate or the effective interest rate at the moment before restructuring.

Moreover, ESBG is sceptical to 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.

Apart from this, ESBG is not convinced that the proposed formula to calculate diminished financial obligation is the right way forward because it appears to be quite different to the ones requested by some national supervisors. Further discussions would be needed in this regard. Please also see our answer to question 7 in this regard.

<u>Question 6:</u> 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 disagree with this logic. If a lender decides to buy a financial asset, the price ought to reflect the value of the asset at that point in time and this is regardless of whether the price has a material discount. A material discount can be the result other than financial distress, such as general changes to market conditions and a result of negotiations, e.g. settling other transactions. Therefore, it seems unreasonable that the discount as such should be an indicator of unlikeliness to pay. Such assessment is normally a part of the due diligence of the asset to be bought, to be able to establish a relevant value/price of the asset.

Apart from this, considering that the sale and purchase of a credit obligation can be seen as, so to speak, the two sides of the same coin, it would be important to have a symmetrical definition with regard to the sale/purchase at a discounted price.

<u>Question 7:</u> 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?

Regardless of the fact that we understand if one adopts the point of view that institutions are best suited to judge when a customer or an individual credit facility is no longer in default and therefore a probation period is not absolutely necessary, ESBG agrees that, regarding the defaults that are recognised via the distressed restructuring route, there could be a probation period in order to assess whether revised terms and conditions of the contract and/or payment schedule are met.

In this respect, we would like to suggest a probation period with a qualitative assessment and with a test going into the direction of the IFRS 9 framework. If accounting and risk measures are treated too differently in this respect, we fear that unnecessary complexity and confusion, in particular to investors, could be the result. The focus during the qualitative assessment should be on whether the customer has met the newly agreed upon payment schedule or revised contract. ESBG suggests to leave the material payment that equals the written-off amount out of the equation. The consultation paper mentions that a material payment (a total equal to the amount that was previously past-due (if there were past-due amounts) or that has been written-off (if there were no past-due amounts) under the restructuring measures) has to be made by the borrower. However, if the repayment of the written-off amount is a requirement to enable a defaulted exposure to return to the non-defaulted status, many customers will not be able to make this material payment. As a consequence, the exposures will remain for a long time/forever in the defaulted status and, as already stated in answer to question 3, the EBA could in our opinion try to avoid this last issue to happen because the state of the exposure should ideally reflect its real credit quality. This would also lead to everlasting registrations at the national credit registries, having negative consequences for customers.

To leave the material payment out also prevents difficult situations in which a revision of contract was made but did not lead to a write-off. The application of a different interest rate as a forbearance measure may serve as an example. This would lead to lower future interest income for the bank, but would not lead to a write-off from an accounting point of view.

Regardless of the fact that we agree that the EBA's guidelines should not be exclusively written in the spirit of IFRS 9, it should be considered that the prudential and the accounting frameworks don't drift too much apart in this context.

This question also relates to question 1, namely, should the default be a result of data or system errors of the customer when processing the payment, a three month probation period is too long. In case such errors lead to customers being classified as defaulted, a return to non-default status as soon as the obligation is paid in full is more reasonable.

<u>Question 8:</u> Do you agree with the proposed approach as regards the level of application of the definition of default for retail exposures?

Generally speaking, ESBG agrees with the proposed approach. However, as mentioned above, we would like to state that no additional, unjustified differences should be created between the prudential and the accounting frameworks.

<u>Question 10:</u> Do you agree with the approach proposed for the application of materiality threshold to joint credit obligations?

ESBG has some concerns with regard to a possible 'contagion' between personal and business accounts, in particular in the SME sector. Therefore, we believe that the proposed approach is in some parts not appropriate. In some jurisdictions this could lead to serious issues.

We also have concerns regarding Paragraph 85 of the draft guidelines. Indeed, we think this article could be deleted because it requires the entities to collect some information that is not easily available or up to date. For instance, to know when the marital status of a person changes is not as simple as it might seem.

Finally, we don't agree that passing the materiality threshold for the joint obligation should imply the contagion of individual obligations of the parts included in the joint obligation. ESBG believes this should be evaluated on case-by-case basis by institutions. In some cases this could reflect a dispute between the parts of the obligation, and at the same time not be related to the credit quality.

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

As the change of default definition is a material change, ESBG does not see any issues in involving the management body for approval of implementation of default definition. The same is true with regard to the internal audit review. We, however, see possible obstacles with 'use test'.

Furthermore, ESBG would like to emphasise the importance of the accounting and prudential frameworks to have coherent objectives for governance procedures, avoiding the duplication of reporting to the senior management body due to unjustified divergences between both frameworks.

About WSBI (World Savings and Retail Banking Institute)

WSBI brings together savings and retail banks in all continents and represents the interest of circa 6,000 financial institutions with total assets of USD 14 trillion and serving some 1 billion customers in 80 countries worldwide (2013 figures). As a global institution, WSBI focuses on international regulatory issues that affect the savings and retail banking industry. It supports the aims of the G20 in achieving sustainable, inclusive and balanced growth and job creation around the world, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalization that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. It supports a diversified range of financial services that meet customers' transaction, savings and borrowing needs responsibly. To these ends, WBI recognizes that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It therefore fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed and inclusive financial institutions.

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About ESBG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of €6,749 billion, non-bank deposits of €3,415 billion and non-bank loans of €3,685 billion (31 December 2013).

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