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FBF RESPONSE TO EBA CONSULTATION PAPER ON THE APPLICATION OF THE DEFINITION OF DEFAULT (EBA/CP/2015/15)

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the EBA's Consultation on the application of the definition of default. Please find our main comments below and our detailed feedback within our answers to the EBA's questions.

I- General comments

As a key message, we would like to underline that the EBA's proposed guidelines for the definition of default should leave some room for expert judgment. A too systematic application of the definition of default may have unintended consequences, some of which are illustrated below and detailed further in our answers to the EBA's questions.

Indeed, the EBA's proposals may in some cases put counterparties in default for inappropriate reasons – i.e. not linked to credit assessment – and thus disconnect the default status from the economic reality of the counterparty. For example, an obligor may be declared defaulted not because of financial difficulties but due to an inadequate definition of default (e.g. technical default due to commercial disputes, sale of a credit with a discount, etc.., please see our answer to question 1 for further details) which may hinder the capacity of this obligor to be funded. The risk to disconnect the notion of default from the economic reality of the counterparty is acute, with a "regulatory default" potentially not taken into consideration as part of the credit decision, thus weakening the implementation of the Basel framework "use test" –i.e. the notion that IRB parameters play an essential role in how banks measure and manage risk in their businesses

Furthermore, if the EBA intends to apply its proposed application of the default definition retrospectively, a simplified methodology needs to be considered for the adjustment of data, in order to minimise the workload for banks and to ensure comparability.

Moreover, it will also be crucial to implement the new proposed application of the definition of default simultaneously with the ongoing revision on the whole of internal rating methodologies. This may entail internal models recalibration and, to a certain extent, revalidation of IRB parameters.

We would like to take this opportunity to underline the fact that sufficient time needs to be granted to change the operative procedures and banks systems, including changes to IT systems, policies, data and data structures, and human resources. The time necessary for obtaining supervisory approval of banks' internal models, where needed, should be factored on top, as banks are not in control of the supervisory timelines. French banks are committed to doing their best efforts in order to keep their overall internal processes as efficient and streamlined as possible.

In addition, we would like to draw the EBA's attention to the need to keep consistency with IFRS9 definitions. French banks are aware of the fact that the EBA's guidelines are not introducing any interpretation of the accounting framework; nonetheless it is important that prudential definitions, for example, of the default and of the unlikeliness to pay are clarified in relation to their analogous notions in the accounting world.

Finally, the EU Commission is working on a European label of "Simple Standard and Transparent" (STS) securitisation. Among the criteria contemplated for this label, the Commission proposes that no underlying exposure in default (as defined in article 178 of CRR) should be included in the pool of securitised exposures. A definition of default that would include exposures sold or bought with a discount above a certain threshold or for which a commercial dispute exist, may result in making a wide range of counterparts ineligible to securitisation transactions. We believe it is therefore key for the STS label success that exposures underlying a securitisation vehicle may not be submitted to a too systematic definition of default application as the STS framework overall requirements effectively ensure its resilience.

Areas requiring further clarification:

Daily basis counting past due

In paragraphs 19 and 91, it is stated that the past due counting must be performed on a daily basis. Where an automatic process is applied (paragraph 91a), we understand that:

- The daily basis counting begins when the amount past due breaches the threshold.
- An exposure will be considered as defaulted when the materiality threshold has been breached for over 90 consecutive days.

However, even if a counting past due is done on a daily basis, we recommend processing defaults at month end only; i.e. an obligor who has breached the materiality threshold for 90 consecutive days, mid-month, will be considered as a defaulted counterpart in the calibration population at month end, regardless of whether he is back within limits before month end.

Unlikeliness to pay criteria –leverage ratio

As an additional point, the leverage ratio seems to be another indication of unlikeliness to pay quite constraining and not economically justifiable if taken in isolation: "(c) the borrower's overall leverage level has significantly increased or there are justified expectations of such changes to leverage". While the borrower's overall leverage level is a useful risk parameter, it should not be considered in isolation; it would be indeed counter-intuitive to consider that a significant increase in leverage should be automatically considered as an event of default.

II- Answer to questions related to the consultation

1. Do you agree with the proposed definition of technical defaults? Do you believe that other situations should be included in this definition? If yes, please provide detailed proposals on how to address further possible situations.

The definition of technical default expressed in the paper is too restrictive: actually, all non-payments not due to credit reasons would be considered as defaults except for the two cases quoted in the Consultative Paper. This would represent a sizeable change compared to the current practice on non-retail activities where expert judgment is largely used to determine whether a past due situation is pertaining to technical default or not.

The approach proposed by the EBA requires a much more extensive definition of a technical default situations in non-retail activities, for example resulting in past due exposure of more than 90 days, but not due to a credit deterioration of the counterparty. Please find below a non-exhaustive list of such situations to be added in our sense to the definition of technical default:

- Commercial disputes with a customer in the case of leasing activity when the quality of the delivered product / service is contested.
- Commercial disputes in the case of factoring activity. For example, when there is a contestation, litigation or discussion on the invoice between the client and the debtor. This will often be unknown to the factor and could lead also to damaging contagion effects.
- Commercial dispute on a “Stand by letter of credit” (SBLC) would put in default a bank or a large corporate with a potential contagion effect in the case of a syndication of the SBLC (i.e.: all participating EU banks would place the corporate in default, resulting in a possible limitation of the customer’s access to credit).
- Call of suretyship where the suretyship contest the legitimacy of the call which entails a past due situation (case of unfair/abusive claim).
- Syndication arrangements: the agent takes routinely more than 90 days to pay lenders; this practice is without any link to the borrower’s current situation.
- Long administrative processes to give payment authorizations. For example, transfers of loans between Local authorities require a period of time way beyond the 90 days period. The current French “territorial reform”, following the simplification objective favoured by European authorities, will lead to numerous transfers and delays in the coming years, independent from the financial situation of the counterparties involved.
- Logistic process issues for Energy & Commodities financing or generally for Trade Finance: all reasons which lead to delivery delays. For example, merchandise blocked at the customs, prohibition on entering or leaving ports, strike actions…
- Disputes regarding the amount or the nature of collateral in case of margin calls.
- As for asset financing long term loans, amendments/waivers or consents are possible due to – for example – a lack of customer responsiveness, maintenance check of products, reality check of the financing according to new market conditions. Expert assessment is essential.
- Specific cases of sovereign counterparts, for which default may be assessed at political level.
- In general, cases of force majeure (environmental disasters, legally imposed measures, riots, strikes, wars…).

We would like to take this opportunity to underline that a too restrictive definition of technical default will only lead to a higher number of multiple defaults and will certainly create some “noise” in the default information due to additional “non-credit” related defaults. Moreover, commercial disputes are solved over long periods (often many years) which would mean that a borrower would stay in default during this period. However, we believe the proposed approach might be acceptable for an application to retail counterparties where a more mechanical stance seems adequate.

A major risk of this too restrictive definition is to decrease the pertinence of models and to reduce the incentive of the “use tests” on non-retail counterparties. This is likely to strongly increase the default rate and consequently, the allowance of credit loss (cost of risk) of the bank at constant perimeter in terms of activity and risk profile.

As already recommended by IIF RWA Task Force, it would be more risk-sensitive to keep flexibility and expert judgement for specific cases.

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.

We appreciate that the EBA gives credence to the specificity of the factoring activity.

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

We welcome the EBA proposal to anticipate the implementation of IFRS 9 and to leverage as far as practicable on the accounting framework. It is indeed important to avoid inconsistencies with the accounting treatment as much as possible.

Stage 3 of IFRS 9 includes exposures that are credit-impaired (e.g.: significant financial difficulty of the obligor, breach of contract, concession granted due to financial difficulty, probable bankruptcy of the borrower etc.…). Accordingly, we agree that stage 3 exposures will be generally considered as defaulted and stage 2 as non defaulted, though we realise that there may be some exceptions.

However, while defaulted exposures would end up in stage 3 under IFRS 9, the other way around might not be true. There might be situations where some stage 3 exposures would not be defaulted, for instance where national options exist, as rightly pointed out in the consultation paper, but also due to technical defaults (please see answer to question 1 above).

Besides, while we welcome the clarification made by the EBA that the “incurred but not reported losses” (IBNR) should not be considered as an indication of unlikeliness to pay (paragraph 26 of the CP), we consider that such a clarification should encompass stage 2 of IFRS 9.

Indeed, beyond the IBNR which is a current notion of IAS 39, it should be clearly stated that the IFRS 9 stage 2 should generally not be considered as an indication of default. This is all the more important as article 178.3 b) of the CRR mentions “a significant perceived decline in credit quality” as an indication of unlikeliness to pay; this might be misleading and wrongly liken to the stage 2 of IFRS 9 (“significant increase in credit risk”).

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

The rule related to the sale of credit obligations seems very constraining as a mere [5%] decrease in the nominal value would induce a default of the obligor and related contagion effects on its other exposures within a banking group. This is over-restrictive, does not reflect the reality and would have the following unintended effects:

- Threshold/cliff effect: recent history (2008) has proved that when financial markets are highly volatile, some bonds could be under 95% of their par value because the markets anticipate a future decrease of the credit market without the issuer being itself in default.
- Perverse effect: the bank may cease granting facilities to the obligor who may incur an actual payment default.
- In a deleveraging period or for portfolio management purposes, this may incite the sale of good quality assets only, in order to avoid a defaulted categorization of the other assets issued by the counterparty.
- A bank may sell assets for other reason than the anticipation of a decrease in credit quality of the issuer. A decision to sell participations in loans on performing clients at a significant loss may be dictated by:
    - Regulatory capital savings or employment
    - Liquidity management
    - Balance sheet management
    - Country envelope consumption
    - Counterparty exposure management
    - Single limit concentration management
- A fixed threshold does not take into account the maturity of the credit obligation –the pricing impact of a credit deterioration will not be the same on an obligation if its residual maturity is 1 year or 10 years. Furthermore, the credit obligations market may not always be liquid, hence the decision of a bank to sell a significant exposure on a client may cause a pricing shift not necessarily correlated to that client's creditworthiness.

As a consequence, we consider this approach inappropriate in its spirit as it does not heed a true assessment of the credit risk of the counterparty and might induce too many perverse effects.

We deem that expert judgment should be included in this appreciation. We think that the proposed treatment could be instead considered as another criterion of unlikeliness to pay in association with other indicators.

Finally, the proposed treatment could also be incompatible with the approach proposed in the distressed restructuring chapter: a default could be triggered by a discounted sale of an obligation, while a distressed restructuring respecting the 1% rule would not trigger the default of the same counterparty.

We understand that the EBA aims here at preventing credit institutions from selling assets before they become in default in order to avoid an impact on the internal PD. We would like to propose an alternative approach to this situation in order to avoid defaulting all counterparties for which a discount is higher than 5%. We therefore suggest the EBA to replace paragraph 32 with the following:

Where however the loss on the sale of credit obligations is related to the credit quality of these obligations, in particular where the institution sells the credit obligations due to an anticipation of a certain future default, the institution should consider that the borrower is in default.

Generally speaking, we understand from paragraphs on distressed restructuring that the scope of exposures on which the diminished financial obligation has to be calculated is restricted to forborne exposures, meaning to cases in which concessions have been extended towards a debtor facing or about to face difficulties in meeting its financial commitments. More particularly, we would like the final guidelines to state explicitly that renegotiations in which concessions can be granted due to commercial reasons (as opposed to due to financial difficulties of the client) are not in the scope of these paragraphs. Those renegotiations could lead to diminished financial obligations because of market conditions and should not trigger default for the obligors.

In addition to the example in Q6, please find in the annex an example of investment grade loans quotes illustrating cases where the loan is negotiated below 95% of par without being in or close to default.

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

On the basis of paragraphs 38 to 41 of the proposed guidelines, we understand that:

- The notion of "forborne exposure" is equivalent to the notion of "distressed restructuring". By definition, distressed restructuring should be considered to have occurred when forbearance measures have been extended towards a debtor as specified in the ITS on forbearance and non-performing exposures.
- However, a forborne exposure/distressed restructuring is not necessarily non-performing or defaulted; a borrower may repay in full according to the post renegotiation schedule.
- A forborne exposure/distressed restructuring should be considered as defaulted when a material diminished financial obligation is observed. In other words, it should be classified as defaulted if the diminished financial obligation exceeds a certain threshold. This threshold is set by the institution. However, the threshold should not be higher than 1%.

We believe that the cap of 1% is too low. A distressed restructuring could be classified as defaulted with an immaterial diminished financial obligation. We would consider a cap of 5% to be more appropriate.

Inconsistencies with accounting treatment should be avoided as much as possible. Accordingly, the interest rate used should be aligned with the one applied for accounting treatment, i.e.:

- the original interest rate or an approximation thereof for fixed-interest rate loans;

- for variable interest rate loans, the current effective interest rate (consistently with the rate used to project cash flows).

6. 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?

As stated in question 4, basing the definition of default on the price of an asset is not appropriate.

This would indeed have a pernicious effect as banks will have an incentive not to purchase discounted assets in order to avoid to put the borrower in default on their data systems, this would be an issue especially if banks are already exposed to the issuer. From an economic standpoint, we cannot ignore the fact that banks act as intermediaries on markets and that purchased receivables management is an integral part of the banking sector's activity.

In paragraph 47, G (other indications of unlikeliness to pay), "assets purchased or originated at a material discount" should NOT be considered as a possible indication of unlikeliness to pay.

For instance, the following revolving credit facility has been recently proposed to banks:

- Metals and mining company
- Margin: LIBOR +85
- Maturity: May 15, 2020
- Facility Size: $3.0 billion Senior Revolving Credit Facility
- Offering Amount: $25mm
- Price/Par value: 84%

With a discount up to 16%, the counterparty would have been declared in default according to the proposed definition. Nonetheless, the borrowing company is still rated Baa3/BBB+ by external credit agencies, while recently downgraded further to a technical event on a dam it is operating.

We therefore disagree with this proposal: it would trigger default for reasons which are independent from the credit risk of the counterparty. Moreover, this is not consistent with the incentive to use Basel parameters to assess credit risks nor with the notion of "use test".

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

We understand the will to hinder multiple default cases by imposing a probation period. However, the proposed 3 months period might be too long in certain cases and would require important adaptations of the current rules regarding management of defaulted clients.

The rule regarding the return to non-defaulted status will induce a lot of issues, namely regarding modelling and operational monitoring.

We believe that the rule should be refutable in order to allow taking into account certain situations such as the repurchasing of a defaulted client (for example a bank) by a sound counterparty.

The rules regarding the counting of days should be considered independently from the rules regarding distressed restructuring. Thus an obligor could be in default because of a distressed restructuring, while not being past due thanks to the restructuration.

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

We agree with the proposed approach for retail exposures. Our retail activities strike not only transactional relationships with our clients but also fiduciary and middle/long-term relationships with them.

Nonetheless, we note that the contagion from the professional to the personal accounts (or vice versa) of a given counterpart should not be applied systematically but should be decided on an expert basis.

9. 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?

In some cases, isolating credit facilities and identifying the defaulted exposures amid others is not clear cut, e.g. when a mortgage payment is automatically assigned to another credit facility.

Some banking arrangements stipulate that some overdrafts can be indeed automatically compensated by cash from another account of a given client. Sometimes, these accounts are managed by the same banking group but by different legal entities. We think that legal restrictions linked to confidentiality could prevent the possibility to consolidate the defaults between different legal entities of our institution. The application of this pulling effect approach would be operationally very expensive.

The rules for the calculation of the days past due and the materiality threshold at the consolidated level would be complex to define and implement. In a word, the added value of this approach would be low.

As already stated in the introduction, the leverage ratio seems to be another indication of unlikeliness to pay quite constraining and not economically justifiable if taken in isolation: "(c) the borrower’s overall leverage level has significantly increased or there are justified expectations of such changes to leverage". While the borrower’s overall leverage level is a useful risk parameter, it should not be considered in isolation; it would be indeed counter-intuitive to consider that a significant increase in leverage should be automatically considered as an event of default.

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

We understand that:

- In the event a joint credit obligation is identified as defaulted, all individual obligors linked to this joint obligation are also considered as defaulted.
- Other joint obligations between one of these defaulted obligors and other non-defaulted obligors are not systematically defaulted.
- When one but not all individual obligor(s) is/are defaulted, there is no systematic contagion towards joint credit obligations, although this may be extended on an expert basis.
- When all individual obligors are defaulted, the joint credit obligations is also considered defaulted.

A global reflection about materiality thresholds shall be considered as far as it may raise competitive issues between Member States (e.g. in France, the past due is presumed significant as from the first 1€ in default). In some countries a 200 euros threshold already represents a significant amount. We think that "a maximum" threshold would be more efficient than a strictly imposed limit, with the possibility to reduce the threshold based on the loan / context reality.

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

We agree with these requirements which banks by and large already meet. This seems to be already in line with CRD 4 requirements.

We would like to take this opportunity to draw the EBA's attention on the following points:

Coordination with the Basel Committee Guidelines:

As a point of attention, we underline that the Basel Committee already launched guidelines on credit risk management processes to be applied further to the application of IFRS 9. It is crucial to ensure that there will be no contradiction between both sets of requirements.

Tentative calendar:

We understand EBA requires banks to incorporate the new default definition into their internal procedures/IT systems and adjust accordingly their rating systems by the end of 2019 (including competent authority model approval). In order to meet this deadline, this leaves us four years to do the below mentioned steps in the following order:

1. Launch the necessary developments in order to incorporate the new definition in the IT system
2. Observe new defaults. A minimum observation period of 12 months is required
3. Assess the impact of this definition on rating models, in order to determine if models should be recalibrated or rebuilt
4. Recalibrate or rebuild the models
5. Obtain approval by the bank's internal model validation team

Please note that the implementation process is burdensome and may imply material changes from an IT perspective.

LIFO / FIFO approach:

- The daily basis counting begins when the amount past due breaches the threshold.
- An exposure will be considered as defaulted when the materiality threshold will be breached over 90 consecutive days.

ANNEX: Corporate & Emerging Market Loan Quote Sheet – sample extract

Borrower	Country	Ccy	Sector	Type	Size (m)	Maturity	Margin (bps)	Rating	Bid	Offer
Qatar Chemical (Qchem II)	Qatar	USD	Chemical	TL	1,440	Jan-20	50		93.000	95.000
Qatar Steel	Qatar	USD	Metals	TL	483	Jan-18	100		94.000	96.000
Qatargas II	Qatar	USD	Oil&Gas	TL	3,600	Jan-20	115		99.000	100.000
Qatargas III	Qatar	USD	Oil&Gas	TL	2,788	Jul-22	60		97.500	99.000
Qatargas IV	Qatar	USD	Oil&Gas	TL	3,968	Feb-23	30		95.000	98.000
Qatofin	Qatar	USD	Oil&Gas	TL	760	Nov-20	50		95.000	97.000
Sadara Chemical	Saudi Arabia	USD	Chemical	P/R	10,504	Dec-29	125		97.500	99.000
Salik	Dubai	USD	Transport	TL	800	Jun-17	325		99.500	100.500
Saudi Arabian Mining (Maaden)	Saudi Arabia	USD	Metals	TL	2,361	Jun-24	80		93.000	95.000
Shuweihat S2 IWPP	Dubai	USD	Power	TL	780	Aug-31	235		99.250	100.000
Shuweihat S3 IWPP	Dubai	USD	Power	TL	1,162	Jun-34	175		98.750	99.750
Sloe Centrale	Netherlands	USD	Electricity	TL	510	Mar-26	70		CALL	DESK
Sohar Aluminium Co LLC	Oman	USD	Metals	TL (Islam.)	1,460	Apr-21	95		93.000	95.000
Sohar Power	Oman	USD	Power	TL	446	Mar-25	80		92.000	94.000
South Hook	UK	GBP	Oil&Gas	TL	480	Dec-29	105		CALL	DESK
Taweelah B IWPP	Abu Dhabi	USD	Power	TL	911	Jun-25	65		91.000	93.000
Tramwaje Warszawski	Poland	PLN	Infrastructure	TL	200	Jul-25	220		CALL	DESK
Transitgas	Switzerland	CHF	Infrastructure	TL	1,043	Sep-21			99.000	100.000
Wembley Stadium	UK	GBP	Leisure	TL	342	Sep-23	175		99.000	100.000
Yanbu National Petrochemical Co	Saudi Arabia	USD	Chemical	TL	3,383	Jul-18	65		CALL	DESK
Yemen LNG	Yemen	USD	Oil&Gas	TL	648	Feb-20	210		CALL	DESK