German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

On the European Banking Authority´s (EBA) Consultation Paper "Draft Regulatory Technical Standards on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013" – EBA/CP/2014/32

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Comments on the European Banking Authority´s (EBA) Consultation Paper "Draft Regulatory Technical Standards on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013" – EBA/CP/2014/32

Ladies and Gentlemen,

we like to thank you for the possibility to comment on the European Banking Authority´s (EBA) Consultation Paper "Draft Regulatory Technical Standards on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013", published October 31, 2014.

Remark on "Definition of credit obligation past due"

The draft RTS shows inter alia two different options 3 and 4 for the "definition of credit obligation past due":

- Option 3 "The sum of the amounts past due more than 90 days (or 180 days if applicable)"
- Option 4 "The sum of the amounts past due more than 90 days (or 180 days if applicable) but the calculation of days past due starts when the materiality threshold is breached"
  with the same advantages and disadvantages as option 3, but with the additional disadvantage:
  - "The counting of DPD is not compliant with contractual obligations of the institution and other purposes where DPD number is used, in particular internal monitoring of credit portfolio"

The draft RTS states on p. 24 (a. Definition of credit obligation past due) that option 3

a. seems to reflect the intention of article 178,
b. is commonly used across Member States (and therefore would generate on aggregate the least cost for them) and
c. is the preferred option, given the advantages and disadvantages of all options (so obviously the additional disadvantage of option 4 was relevant)

a. Firstly, we do think that especially option 4 does mostly reflect the intention of article 178 which explicitly refers to "the obligor is past due more than 90 days on any material credit obligation". The mentioned "material credit obligation" obviously means only just this obliged amount which is in arrears (cf. definition of "credit obligation past due" in draft RTS), so that article 178 says that the "*material* credit obligation past due" must be 90 days in arrears. Consequently, as long as this amount in arrears is *not material* it shall not be subject of counting for "90 days past due" to our understanding.

b. Additionally, we were wondering about the statement that option 3 is commonly used across member states, because in the draft RTF in table 1 (p. 21), there are 8 countries with option 4, none with option 3 and 7 countries with a so-called "case-by-case approach". In the description of the table on p. 20 the following description can be found: "Most common past due definition is 'the sum of the amounts past due more than 90 days (or 180 days if applicable) but the calculation of days past due starts when the materiality threshold is breached'", which obviously is option 4.

c. With respect to the mentioned additional disadvantage of option 4, we can represent our German experience with option 4 which is used for calculation of pillar I capital requirements and preferred by the vast majority of the German banks: Almost all measures which are principally based inter alia on arrears or 90 days past due, like IAS 39 Impairment (Trigger, GLLP), life-time loss estimation, calculation of economic portfolio credit risk, pre-calculation, etc., are usually used also according to option 4 DPD-day

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counting or the corresponding 90 days past due criterion. "Internal monitoring of the credit portfolio" can comprise monitoring and dunning of single transactions as well as the portfolio risk monitoring of exposure amount and number of obligors in arrears. While the latter is usually often also based on the option 4 DPD-day counting, the day counting with single transaction monitoring and dunning will never exactly fit one of the two aforementioned DPD-day counting options if for no other reasons than the fact that these options are based on an obligor and not a single transaction view.

We conclude from the reasons in a., b. and c. that option 4 is much more adequate than option 3 and strongly recommend implementing option 4.

With respect to the definition of the "credit obligation past due" according to Art. 2 (2) lit. a of the Draft RTS, it should be clarified that this is to be understood as a "material part of the overall credit obligation" (sum of the amounts) that is past due. It should be stated that this does not solely refer to adding those amounts past due more than 90 days on a single level. In practice, that implies that the sum of open positions is analyzed on a daily basis. If the sum is continuously above the materiality thresholds for more than 90 days, a default will be considered to have occurred, irrespective of the arrears of single credit obligations.

Consultation 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)?

Current Practice in Germany is the usage of option 2 which was developed by the IRB expert committee. In this model the absolute materiality limit (100 €) works as a floor for the relative materiality limit. If the granted total credit limit is lower or equal 4.000 € the threshold is 100 EUR (regime of absolute limit) and for greater total credit limits 2.5 % of exactly this limit holds ("Bagatelle Curve"). The idea behind this model is that materiality is to be considered basically in relation to the granted total credit limit of bank's debtor:

1 many possible reasons for rather technically driven "overdrafts"[1] are relative to the total credit limit/obligation, like fees and interests
2 banks prioritize the investigation/fixing of technical overdrafts according to the inherent risk (consequently, e.g. 1.000 € technical overdraft with an 10.000 € loan will be investigated and fixed prior to an 1.000 € overdraft with an 100.000 € loan, given the same obligor rating)
3 generally, bank's competence rules on overdrafts are very often related, inter alia, to relative amounts of credit limits

[1] „Overdraft" is used as a general term and comprises "obligations past due" with non-revolving loans as well as "overdrafts" on revolving loans

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The absolute materiality limit prevents the rule from dealing with materiality limits like 10 or 50 €, which are very small from the German jurisdiction perspective.

Option 1 is rather working the other way round and is therefore counterintuitive (with proposed materiality values of 200 €/2 % for retail as example):

a. beyond a total credit obligation of 10.000 €, the materiality threshold is constantly 200 €, no matter if the obligation is a 10.000 € car financing or a 400.000 € residential mortgage loan (cf. arguments no. 1 – 3)
b. below a total credit obligation of 10.000 €, the materiality threshold starts with strangely small amounts like e.g. 40 € for a credit obligation of a 2.000 € furniture financing and linearly goes up to 200 €
c. If "credit obligation" is defined as the amount currently owed by the debtor (including past due amounts) and not the credit limit, the relative materiality amount increases with increasing past due amounts and so may be unfortunately driven by the debtor's behavior (which is clearly not intended)
d. On the other hand, if "credit obligation" is defined as the currently granted total limit (excluding past due amounts) and thus is independent of increasing past due amounts, very prevalent technical small overdrafts on zero limit accounts (e.g. 5 € fee booked on redeemed mortgage loan account) will be material after the first €-Cent

Thus, the implementation of option 1 will significantly increase the number of those default cases where obligors do not have imminent problems regarding their creditworthiness. As a consequence, option 1 will lead to higher efforts related to bank's default handling processes and will reduce the potential statistical power in rating model development due to an higher amount of cases without the real pattern of default in their rating attributes.

In summary, option 1 has many characteristics which we consider as neither economically comprehensible nor compatible to the bank's processes and risk-oriented approaches, so that we clearly disagree with option 1 and strongly recommend choosing option 2 as the possibility to be implemented (cf. also discussion on maximum levels).

The points c and d mentioned above indicate that the term "all credit obligations" can be interpreted in different ways. Hence, an unambiguous definition of that term is necessary with respect to Art. 2 (2) lit. b of the Draft RTS. In Germany, the term is defined as the overall loan currently granted, i.e. excluding the amount past due.

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

In general, the proposed absolute maximum levels (200/500 €) of the thresholds are pretty sufficient for the preferred option 2.

On the other hand, option 1 features considerable insufficiencies and inconsistencies that an increased absolute maximum level of the thresholds cannot really equalize this.

Analogously, with the preferred option 2 a differentiation between retail and non-retail is already included more or less in the relative model. Above all, two different threshold amounts have the inherent problem that there is a mismatch at the joint between them. On the one hand an SME with a 300.000 € obligation

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with the banking group, which is treated in a retail-like process and thus classified in the asset class retail will have a materiality threshold of 200 €. On the other hand a very similar corporate with the same obligation with the banking group, processed in the same way as the aforementioned SME, but treated in the corporate asset class will have a materiality threshold of 500 €.

This may also rise problematic breaks in the basic modeling data of corporate rating systems including partially obligors in the retail asset class, like e.g. a corporate rating system with sales/total assets from 5m to 200m € as its range of application.

For continuity and economical reasons (cf. also answers Q3/Q4) we would also prefer to increase the relative maximum level from 2 % to 2.5 % as a refinement. Even smaller modifications of the default definition would impose considerable efforts on IRBA-institutions.
Option 2 would not produce such discontinuities so that the aforementioned arguments additionally support to choose option 2.

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?

For us this clearly depends strongly on the chosen option in Q1. In case of option 1 that changes the definition of default in Germany, existing default time series used so far for validation and calibration purposes of all PD, LGD and EAD rating systems must be more than slightly adapted in German banks. And a large set of additional credit obligations has to be analyzed. As this cannot be done in an exact and sufficient manner retrospectively due to non-availability of data, it will take about 1 – 2 economic cycles (about 5 – 10 years) until this may be completely remedied. Further this will significantly increase the cost of implementation by requiring a parallel implementation of two different default definitions. Additionally, all PD, LGD and EAD rating models are expected to be possibly redeveloped or at least re-calibrated (cf. also Q4) due to the aforementioned changes in time series. However, a recalibration – as it is mentioned in the consultation paper – is only workable if the changes in the definition of default have an equal effect to the relevant portfolios. Nonetheless, this is not the case here, since the effect to the different sub-portfolios and risk drivers may differ. A redevelopment of a model is considerably more extensive and more costly than it is the case for a recalibration.

Furthermore, the validations and model adjustments require the replication of a default detection as well as of more data that is needed for validation and development purposes and that accounts for the new materiality threshold. This procedure is complex and must be supervised intensively due to the default definition´s significance for all models. As a result, the model adjustments require a considerable preliminary lead time for the default definition´s replication.

In this case, we do strongly believe that a transition period of at least 7 years is needed. Alternatively, default time series have to be shortened significantly or the quality of the data will be limited. Both are likely to affect the models negatively.

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Depending on the chosen options in the final RTS, the adjustment of the historic time series is only possible with extreme costs, or nearly impossible. Due to this reason for each institution there should be the possibility in the RTS to avoid the adjustment and make an alternative evaluation of the effect of the change of the materiality threshold on the performance and the calibration of all the affected components of the rating system (PD, LGD and EAD).

Regardless of which option is chosen in Q1, a parallel implementation of a new default definition is practically impossible because the changes relate to IT system and process implementation efforts as well as changes in the credit risk parameter settings and rating models driving the RWA levels. This altogether cannot be maintained in parallel. Effort-wise the following activities have to be performed:

Data basis / IT Systems

- The amount overdue might not be readably available in the data bases / systems used for RWA calculation as well as credit risk parameter and model recalibrations, i.e. interfaces to booking systems or workarounds in the respective data bases /systems need to be established

Credit Risk Parameters / Rating Models

- Validate and recalibrate credit risk parameters and rating models based on the modified default definition. In case of universal banks and depending on the rating system structure this affects a high number of parameter settings to be verified/changed

Process

- Assessment of the implications of the re-calibrated credit risk parameter and rating models
- Internal and external governance process, incl. approval process by supervisory authorities and use test requirements
- Training for credit officers / users of recalibrated rating models
- Implement recalibrated parameter and models (including piloting and test runs)
- Update the respective disclosure requirements

In summary, we strongly recommend finding solutions in this RTS with an adequate leeway to minimize cost of changes for all banks. As an example, we would recommend that the RTS stated that each superordinate organization responsible for the rating models has the possibility to define a fixed date when the calculation of the materiality thresholds is switched from the current used definition to the new definition based on the RTS, after the national competent authorities have set the corresponding absolute and relative limit. Due to the disproportional cost and complexity we think that a parallel calculation of both materiality thresholds should not be necessary.

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

Generally, we agree that the adjustment of data, redevelopment or re-calibration of all risk parameters PD, LGD and EAD, model change application, etc. will impose a significant operational burden especially on the banks that use the IRB approach. We strongly believe that a sufficiently exact adjustment of existing time series retrospectively is almost impossible, so that we recommend giving a definite leeway to further use the unadjusted historic time series. Consequently, a transitional period is needed (cf. Q3) and will additionally cause extra costs like of parallely recording of two different default definitions.

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Especially in case of "Definition of credit obligation past due" we do not believe that option 3 will generate lower costs in the member states than option 4 which additionally will be the more adequate solution (cf. section "Remark on …").

Furthermore, we agree that this significant operational burden comprises not only the area of development and changes of rating models but also adaption of data warehouses, IT-interfaces, calculation engines, processing more (technical) default cases, caesurae in several credit risk reports, processing more impaired loans (in finance), etc. In total, the costs in these several areas of change will easily add up to 7-digit €-amounts per bank.

Thus, we strongly recommend finding solutions in this RTS with an adequate leeway to minimize cost of changes for all banks.

We have strong evidence that the stated benefits would not even come close to being able to compensate the aforementioned costs. Especially for banks with a rather local business model benefits are almost zero. However, even internationally operating banks will probably face different local parameterizations of those thresholds and sometimes deviating 180 DPD in definite segments caused by national discretion under the regime of this RTS. Therefore, in line with the recently published Basel document on national discretion with the intent to eliminate some of these discretion rules[2], we believe that the possibility to use 180 DPD under certain conditions should be eliminated to harmonise the default definition.

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

As a summary, we believe that the primary impacts of this draft RTS are

- needed actions will lead to high implementation costs, if chosen requirements and solutions are not flexible and not adequate for the bank's needs
- institution's resources (in particular also human resources) will be blocked for several years due to the adjustment of the time-series and redevelopment of models
- tendentiously higher PDs but lower LGDs are expected; due to the LGD floor higher own funds requirements are expected; this higher own funds requirements are not covered by higher risk exposure
- at average, banks will deal with more technical defaults and statistical power of rating models may decrease, especially if option 1 together with option 3 ("Definition of credit obligation past due") is chosen
- not an increase in bank's risk management excellence
- overall, there are no substantial benefits for institutions
- European regulator will basically have better comparison of risk figures between banks in different member states (Nevertheless, there is again national discretion for smaller thresholds as well as alternative 180 DPD in definite segments)

The last point can be achieved with our proposed changes, i.e. option 2 together with option 4 ("Definition of credit obligation past due"), as well.

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[2] See BCBS, "Basel capital framework national discretions", 11/2014