European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

EACB Comments On the draft RTS on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013

Brussels, 30th January 2015

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General remarks

The members of the EACB gladly take the opportunity to comment on the proposed EBA draft RTS on materiality threshold of credit obligation past due under Art. 178 CRR.

The paper rightly addresses the relevant factors and implications of setting a materiality threshold for the default definition. We particularly appreciate the analysis of both the current practice across the different Member States and of the implications and significant challenges for the institutions applying different approaches, especially the IRB approach. Bearing in mind the inherent complexity, we understand the challenge that the development this RTS represents for the EBA.

However, we believe that the materiality thresholds proposed do not strike the appropriate balance in distinguishing between the "real" and the "technical" defaults:

- we are concerned that the proposed thresholds would lead the institutions to recognise as defaults too many circumstances where the financial situation of an obligor is not imminently impaired. This would result in unnecessary overprovisioning and superfluous procedures.
- moreover, from a client perspective, it is important to avoid technical defaults. These may be harmful for the customer, as they could lead to unnecessary downgrades in an obligor's credit assessment and damage the customer's financial reputation.

In conclusion, we believe that the default thresholds must not be too restrictive. An overly strict rule would not be healthy and would instead provide inappropriate results. In addition, a complete harmonisation across the EU could have a very significant impact in some jurisdictions, leading to a much bigger effect in some countries.

Finally, the administrative burden linked to the implementation of these provisions should be carefully considered and weighted against the potential benefits, especially for smaller institutions focused on traditional retail banking and local economies. The readaptation of the credit models would be particularly burdensome for these banks.

Answers to specific questions

1. ***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)?***

We favour the alternative option 2, i.e. a default should be considered when ***both*** limits (absolute and relative) are breached. Indeed, one element of the materiality should be based on the total credit exposure of a bank's debtor (relative limit). This element should be complemented by an absolute limit, which aim should be to act as a ***floor*** for this relative materiality limit. This combination would prevent to unnecessarily deal with very small materiality limits (e.g. 100€ for a credit card revolving loan of 5000€).

However, we believe that for portfolios characterised by a large number of individual files, such as retail portfolios, the threshold should be easy to implement in order to avoid the burden represented by the numerous checks. Therefore, for such cases banks may have the option to fix absolute thresholds, in the spirit of the RTS and of the internal risk management processes of the institution.

The implementation of option 1 would lead to the classification as default of situations where the economic reality does not justify it, because the obligors' creditworthiness remains unaffected ("technical" default). Therefore, we do not consider this option as a good predictor of the materialization of credit risk. It would imply that small amounts of client payments not done or not received for reasons other than a default trigger its classification as non-performing exposures (e.g. payment processing errors, etc.). This would create a large number of defaults with return to a non-defaulted status in a short timeframe after the recognition, thus leading to unnecessary overprovisioning, superfluous procedures and compliance efforts. Moreover, since the prudential definition would create technical defaults, banks may also need to develop their own internal default definitions for risk management purposes, which represents an additional impact. Finally, this would also have a negative impact on the client himself.

Since option 1 is very likely to create a large number of defaults with return to a non-defaulted status in a short timeframe after the recognition, we believe that it would not be compatible with EBA's aim as stated on page 7 of the CP: *"the materiality threshold should prevent from recognising too many defaults that will be cured in a short timeframe but at the same time the threshold should not prevent from timely identification of real default cases".*

Should the relative threshold (see next paragraph) correspond to a substantial amount for large exposures, a default would be recognized much earlier via "unlikeliness to pay"-criteria rather than the 90 days past due criterion.

We also see that option 1 is one of the least common in Europe, according to the table provided in the impact assessment (p. 21 CP), which means that its adoption would bring significant change for the vast majority of European banks.

We therefore suggest to **amend Article 2.2(c)** as follows:

> *(c) where **both** of the limits referred to in points (a) and (b) **are** breached, the credit obligation past due shall be considered material, and the obligor shall be considered defaulted.*

Particular cases

Moreover, there are some cases requiring specific treatment:

- There should be a specific override for situations where it can be argued that having material arrears 90 days past due should not be considered a default signal. These conditions are often linked to underlying contractual arrangements. For example: a client may choose not to pay its contractual obligations when his leased product does not function properly. This is common practice for leasing companies. In these cases, the client is capable to pay, but will not do so. Being

90 days past due in this case should not be interpreted as credit risk (or deterioration in creditworthiness of the client).

- Moreover, the administrative specificities in some Member States should be taken into account. This is the case with exposures to public sector entities (central, regional and local), which imply an specific administrative treatment with regard to the debt payment process.

- Finally, as regards exposures related to mortgages, consumer credit and asset finance (e.g. leasing), we suggest that the amount of the installments is considered in the determination of the materiality thresholds (both relative and absolute). Therefore, the latter should be set in a way that they account for at least the amount of a predetermined number (e.g. 2) of installments if that amount is higher than the thresholds.

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

(NB: The following answer is based on the presumption that option 2 (cf. question 1) is chosen and should be read as such.)

We believe that there should be an **absolute threshold** of 1000€. Different analyses show that two absolute thresholds of 200€ (retail) and 500€ (non-retail) lead to unnecessary technical defaults. Clients or facilities with arrears between 200€ and 1000€ will either be cured or will eventually increase resulting in arrears over 1000€ (leading to the recognition of a default). In particular, arrears for amortizing facilities reaching the end of their maturities will unnecessarily trigger the absolute thresholds values in case of arrears. The relative threshold is often "automatically" breached due to the low remaining exposure value.

Nevertheless, as mentioned earlier, we believe that banks should have the option to define absolute thresholds, in line with the RTS, in the case of mass portfolios.

As for the **relative threshold**, we strongly advocate for an increase, to 4%. Selecting a threshold of 2% implies, by definition, an increase of the non-performing exposures at European level. We consider appropriate to raise it to 4% of the total amount of all credit obligations of the borrower. A relative threshold of 2% could be applied in the case that the definition of default is applied at single credit facility level.

Moreover, a relative threshold of 4% would be closer than the proposed 2% to the current EU average (between 2% and 5%). In addition, there are first draft evidences (according to a quantitative analysis performed in several jurisdictions, such as Italy) that the past due cure rate grows not negligibly every 1% step reduction from 4% to 2% of the relative threshold. This witnesses that the EBA proposal does increase (instead of exclude) the number of technical defaults.

Additional aspects

We would like to add other specific remarks in addition to the precedent comments.

Firstly, it should be noted that many banks have offices that deal with different currencies which are more volatile than the Euro. This can lead to complications, non-compliance and incorrect assessment of the default portfolio.

Moreover, additional criteria should be provided for computing the past due amount to be compared against the thresholds. In particular, the possibility of compensating this past due amount with the debtor's undrawn credit lines should be allowed. As another possibility, it should be allowed to consider the sum of all amounts that are past due more than 90 days (or 180 days), as correctly stated in the draft RTS, instead of all amount past due if just any of the amounts is past due more than 90 days (or 180 days).

Finally, recital 3 indicates how to differentiate between retail and non-retail exposures using the CRR as a reference. Such reference should be made clearer as regards the definition of retail exposures. In this regard, we propose the following: *"[…] it would be appropriate to set the absolute component of the threshold at different levels for retail exposures and for all other exposures, separately, where the determination of retail exposures is made in the manner* ***defined in Article 147(5)*** *of Regulation (EU) No 575/2013, for banks applying the IRB approach, and in the manner* ***defined in Article 123*** *of that Regulation for institutions that apply the Standardised Approach."*

3. ***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?***

Considering the diversity in practice across the EU, the time needed for implementation would depend on both the jurisdiction where the institution is based, the approach taken and the envisaged future approach. Therefore, a certain degree of flexibility should be provided for.

A bank applying the IRB approach would need to considerably adapt the default time series used for calibration and validation of ***all*** PD, LGD and EAD rating models around the world. All these models will have to go through a material change process, which will extend the timelines even further. In addition, the existence of two parallel default definitions would require further implementation, thus increasing the cost and time burden. In this regard, the choice of option 1 in Q1 would be even more burdensome.

These adjustments will require the replication of a default detection as well as more data, which is needed for validation and the collection of which will take up to two economic cycles. We regard as the shortest realistic time horizon to implement such changes in 7 years: 5 years of data collection, and the remaining time for parameter re-estimations and model redevelopments. We don't see currently an opportunity to collect default data backwards in such a quality that it would comply with existing standards. Low quality or 'estimated' default data is especially not acceptable, when the change has such dramatic effect on RWAs or Expected Losses.

In other words, 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 currently used definition to the new definition based on the RTS, after the NCAs 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 occur.

Finally, in order to not to reduce implementation time, we propose not to apply, in cases of regulatory changes, the provision in Annex I, Part II, Section 1, point 3 of the Commission Delegated Regulation on material changes for IRB banks[1], which requires competent authorities to approve changes in the definition of default according to Art. 178 of CRR.

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

We agree with the assessment that the lower the materiality threshold, the higher the level of defaulted exposures in the asset class where higher risk weights are assigned, having an impact on the way own funds requirements are calculated.

We also share the view about the complexity that these changes would entail for institutions applying the fundamental and advanced IRB approaches: adjustment of data and models and the redevelopment or re-calibration of all risk parameters (PD, LGD and EAD) would be operationally burdensome. This additional operational burden extends beyond the development and the changes of rating models, since it concerns other areas such as IT-interfaces, data warehouses and calculation engines, among other. The adding up of all these costs could reach unsustainable levels.

The analysis also recognises the additional cost not only for these institutions, but also for the NCAs, that will have to review and guarantee compliance with the new models developed.

Taking into account the benefits identified (greater comparability and easier cross-border operations), we strongly believe that these will be **far from compensating the incurred costs**, especially for those banks predominantly focused on local activities and those currently applying a DPD definition which deviate from the majority. Bearing this in mind, an adequate leeway should be guaranteed so that costs for banks are minimized.

[1] Commission Delegated Regulation (EU) No 529/2014 of 12 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach.

<u>*Calculation of days past due*</u>

As one aim of the materiality threshold to filter those cases in which the default is not material, we believe that it is best to start counting the days past due only after the materiality threshold is breached. This would indeed limit the number of technical defaults.

In this vein, and as regards the costs and benefits of the different options for defining "credit obligation past due" (page 23), it is observed that technical option 4 ("the calculation of days past due starts when the materiality threshold is breached") is mostly used, closely followed by the case-by-case approach. Technical option 4 may also be the least costly from an overall perspective. On the contrary, no country seems to apply option 3 (preferred in the paper). In addition, Art. 178.1 (b) states that "the obligor is past due more than 90 days on any *material* credit obligation […]". As stated above, to our understanding, the mention of materiality implies that the 90 days (or 180 days) counting starts as soon as the obligation past due is material. Therefore, option 4 better reflects the aim of Article 178.

The calculation of the days past due should be an integral part of the proposal. Different interpretations can result in a default for one bank being recognized as such by another bank several months later (or not at all).

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

We realise that there are significant differences across jurisdictions when it comes to the materiality threshold, which could lead to diverse impacts with different degrees of intensity.

From a quantitative perspective, we believe that the proposed draft RTS could lead to a remarkable decrease of the banks capital ratios. This impact stems from two channels:

1) *RWA*: the lower the materiality threshold, the higher the level of defaulted exposures in the asset class where higher risk weights are assigned;

2) *Provisioning*: these changes would entail for institutions applying both Standardized and IRB approaches a significant re-calibration of all risk parameters (e.g. PD) used for computing the impairment provisioning, both individual and collective, with a relevant increase of them.

As stated before, the implementation of the proposed draft RTS would also lead to high implementation costs, which would be especially burdensome if a certain degree of flexibility and appropriate transitional rules are not granted.