Prudential Supervision
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Amsterdam, 9 December 2015

Re: consultation paper definition of default

Dear Sir/Madam,

Please find attached a blog on the issues raised by your consultation paper on the definition of default, which appeared on www.prudentialsupervision.eu on 23 November 2015. I trust you will find the comments and suggestions made there helpful in the finalisation of the standards. In response to the specific questions you raised, in addition to the blog I have the following answers and comments:

- Question 1: the rationale for allowing institutions to ignore technical defaults gives them leeway to stop upgrading their IT systems. If technical defaults lead to the burden to increase capital requirements, it would be an incentive to get their internal organisation in order. I thus do not support this loophole for excluding own fault technical defaults from the 'default' treatment.
- Question 2: I support a separate regime for factoring. An anti-abuse provision might, however, be opportune.
- Question 3: The indicators appear to lack clear external financial market indicators, and equally appear to refer to rather late indicators (e.g. indicators that only need to be looked at when accounting obligations occur). This means that the build up of additional capital is likely to be late, instead of forward looking. When large/systemic obligors such as countries or banks fail, any of the facts that you refer to as indicators will likely build up fast, and should thus also be monitored much more frequently (and acted upon with speed by the institution). The main rule of Art. 178 paragraph 1 of the CRR does not appear to allow such a leisurely approach as envisaged in the indicators mentioned in your consultation paper (even though the examples in the later paragraphs of that article appear to be lacking in any rigour). A better approach would be to research what the best indicators for unlikelihood to pay for non-debt assets that are normally included in the credit risk calculation would be. Think of rising CSD values, or ongoing or rapid decreases in the value of shares or bonds issued by the counterparty (see below and in the attached blog).
- Question 4: If either relatively substantial losses at sale or fair value adjustments occur, all exposures to the obligor should be reassessed for unlikelihood to pay. This to avoid abuse/avoidance by the bank involved, who now can label it as a regular sale even if larger losses are incurred. Phrasing the requirement in a manner that only binds

the bank if it actually officially determines that the loss is ‘credit-related’ gives an opportunity to abuse this guidance (by failing to make such a formal assessment, the bank avoids the follow up under your guidance).

- Question 5: no comment.
- Question 6 and 9: Yes, definitely. Other indicators of unlikeliness to pay should be included, especially based on very specific financial market indicators, such as a specific percentage of loss in value of shares in an obligor, an increase in interest rates on its traded bonds, an increase in CDS premiums. Such indicators can be derived from the experience in the various stages of the subprime crisis, specifically when large banks were starting to fail and when sovereigns were starting to fail. In addition: Pulling or treatment of all obligations of a single name obligor is now too lenient towards the bank. If one obligation is in default, it should at a minimum count as a strong indicator that all due obligations are in default too, and as a reasonably strong indicator that the obligor is unlikely to pay for not yet due obligations. Having to default all exposures only if ‘a significant part’ of all obligations is troubled leaves the build up of capital by increasing capital requirements too late, and open for abuse. If the intent is truly to be forward looking in building up financial buffers, the indicators should be plentiful and stringently applied.
- Question 7: The guidelines on the return to non-defaulted status do not appear to consider their impact on delaying the return of larger obligors (especially systemically important obligors) to non-defaulted status. They appear to ignore financial market indicators that a specific listed obligor (e.g. a bank or a sovereign) is no longer considered to be in default by financial markets or the relevant recipients of collateral that is issued by defaulted obligors (e.g. Greece bonds accepted as collateral by the ECB). There is no clarity on whether supervisors can jointly issue guidelines on how to treat obligations of specific systemically relevant obligors, or of obligations of systemically relevant large numbers of small obligors, leaving regulatory forbearance and non-compliance to individual banks and supervisors, and leaving them open to accusations of intentionally undercapitalising the bank in question.
- Question 8, 10 and 11: no comment.
- Question 9: see question 6.

Separately:

- The definition of bankruptcy is both incorrect and superfluous. ‘All creditors’ is a too demanding requirement. Even in a bankruptcy creditors with security can execute their claim while ignoring the bankruptcy. A better definition would be to refer to the list annexed to the Insolvency Regulation 2015/848, and similar processes for financial institutions under e.g. the BRRD.
- On page 36 and further, institutions are requested to draft definitions for specific types of exposures. Why does EBA not choose to provide such definitions for the main non-debt types of exposures, such as equity or immovable property, or advice the commission to make use of its power to provide such definitions?

If you have any questions, please do not hesitate to contact me.

Best regards,

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23 November 2015

The definition of default under banking rules

Defaulting on your obligations is a clear event. You did not pay when you should, you did not show up when you promised you would, you did not deliver the assets for which you were paid. In financial contracts the list of clear-cut defaults is often expanded by contractually defined additional 'events of default'. Such events of default could include many things that normal people would not call a default, such as reorganizing the group of which the obligor is part, or if the obligor suffers a credit rating decrease. Normally, these 'events' serve to enable the creditor to have a say in restructurings and such. This allows them to avoid their rights being eviscerated by e.g. removing cash out of the legal entity they have a future claim on.

Default reinvented

Banking legislators have also engaged in such reinvention of the term default as applicable to any credit obligation. The starting position is that there are consequences for the amount of financial buffers that a bank needs to hold for each claim on the obligor after it has not been paid for a certain number of days after they became due. Like the drafters of contractual 'events of default', legislators have tried to make the calculation of the required amount of financial buffers more forward looking, and include events when there are 'just' signs of possible future non-payment. For IRB banks this already happened in the old CRD after the introduction of the Basel II version of the capital accord. Under the new CRR, the forward-looking element also applies to banks that use the standardised models to calculate credit risk capital requirements.

The CRR requires supervisors and banks to treat obligors credit as 'defaulted' when there are early warning signs that indicate that the obligor is unlikely to pay in full. If such default as defined in the CRR and its predecessors happens, banks on the standardised approach need to hold more capital against some or even all the claims they have on the obligor (risk weighting them at a headline rate of 150% instead of at the risk weights that would apply on non-defaulted claims of e.g. 0% for sovereign bonds, 20% for unrated banks short term debt, 20% for highly rated banks long term debt, or 100% on unrated corporates; and equivalent changes in the calculation of the probability to default – PD – factor in IRB calculations). Such a default – as in a failure to pay a due claim by an obligor – does not yet trigger obligatory losses. Once losses are certain, they would have to be written down from the bank's capital. Instead, a default only means that more capital needs to be held against the claim to buffer against unexpected losses. Only if events subsequently or simultaneously progress negatively and losses are relatively certain, such 'expected loss' needs to be fully deducted from the CRR-financial buffers. As can be expected, writing down losses is unpopular, but even having to increase financial buffers for a loan after a loan has already been granted can be costly, and thus unpopular with the banks. If the bank is important and thinly capitalised, it may even be unpopular with supervisors.

CRR examples

Luckily for less diligent banks, most of the situations that the CRR subsequently references as examples of 'unlikeliness' to pay in full are drafted to be dependent on their own action. If they for example act in a way that acknowledges that the debtor is in problems (for instance by applying for the bankruptcy of the obligor), they also need to increase their financial buffers. As long as the bank itself does not actually take action or draw conclusions, they can avoid triggering the obligation to acknowledge CRR-default until well after an actual default has occurred, namely until 90 days after the obligor has actually failed to pay. For IRB banks it can even be postponed until 180 days have passed without payment after a claim for interest or principal became due in the few member states that use a supervisory discretion to deal with apparently slow payment systems or for instance badly behaved debtors in the public sector. This national discretion expired for the smaller banks that use the standardised approach already in 2011, but the large IRB banks in countries with apparently slow payment traditions such as France and Great Britain can continue to treat slow payers – e.g. municipalities – as if they are solid obligors. Even if the stricter 90 days is applied, this still means that less diligent banks can escape increasing their financial buffers for at least 3 months after a claim became due. This is not very forward looking, unless the bank is proactive in managing its risky exposures and wants to pay attention – as is the CRR obligation – to indications of non-payment.

The indicators for unlikeliness to pay – as copied unchanged from the old IRB provisions in the CRD – include that the bank recognises a significant perceived decline in credit quality, sells (part of) the exposure at a relevant loss, agrees to a distressed restructuring with negative financial adjustments, asks for the bankruptcy (!) of the client, or if the client actually is bankrupt. This fine example of legislative prose means that according to legislators even a court proclaiming the bankruptcy of the debtor is only an indicator of unlikeliness to pay, and still only means that the exposure to the bankrupt client needs to be weighed at 150%, unless the bank itself determines that loss is certain and the exposure written down accordingly (after which they can risk weight the reduced value of the exposure at a lower risk weight again).

No consistency in application

Remarkably, as part of their monitoring EBA and the SSM supervisors have found that not all banks apply the rules in the same manner, and that the national interpretations (and application of the 180 days of non-payment of past due payments before being forced to acknowledge that the debtor may be troubled) lead to different capital levels for debt portfolios with the same risk profile. Some banks delay finding an event of default, and thus delay applying a higher risk weight or PD to the calculation for the minimum amount of capital they need to hold. Some government bodies are allowed some extra time by the local supervisors to pay their debts, even though the risk is the same or higher than in a similar debt just across the border in another member state. Some less principled banks could even opt to sell almost due bonds owed by a troubled debtor at (fire sale) market prices without formally acknowledging this as an indicator of default, to avoid having to consider whether the rest of the debt of that obligor in default when the debtor fails to fork over the repayment of the short dated bonds. CRR legislators were aware of the issue, but failed to reach a compromise on a solution. Instead, they have added to the existing definition an order to EBA the order to monitor the application of this definition, to come up by 2017 with a report on the 90 or 180 days past due issue,

and (without a deadline) to provide non-binding guidelines on how default should be understood and applied by banks in the EU. The SSM has identified the 90/180 days issue as a major impediment to its working practices, and is aiming to pre-empt the 2017 EBA review for the Eurozone member states (of the couple of member state competent authorities that apply this leniency, only the UK supervisors would be able to continue to apply the supervisory discretion, as they will not be bound by the ECB choice on behalf of the Eurozone competent authorities).

As acknowledging the potential for default is core to preparing for recessions and asset based crisis at banks, it is good that EBA has already spent some of its scarce resources to find indicators on how a well set up bank that diligently monitors the credit quality of its debtors should be able to avoid its own future default by taking timely action should do this. Their consultation paper is not a perfect paper yet, but nonetheless it raises the standard for less diligent banks. It for instance implies more clearly that banks cannot limit themselves to the CRR examples of indicators, but actually should look for indicators that the obligor may perhaps not pay to determine whether it is unlikely to pay. Self evident as that sounds, it may be good to reinforce the main rule of heightening financial buffers when it becomes more likely that those are needed, not looking only at the badly written subsequent examples in the CRR provisions, that might lead to fatal delays to shore up buffers when e.g. your sovereign is failing, or when one of the major banks of your country is failing.

(Un)intended consequences?

The consultation paper also raises question, however. Was the spirit of these rules - to prepare for future write-downs by all types of obligors - applied in full in this manner by banks (and their supervisors) when the possibility of default was high in the last few years? For instance when the US government shut down, or when several Eurozone countries were (not yet sure that they would be) bailed out? It is unlikely that this was the case. A part explanation may be that for member states it may have been equally welcome to have optimistic banks that do not apply the indicators of unlikeliness to pay too diligently, and preferably not at all to the government itself, to large banks and to protected sectors. The consultation paper appears to ignore that the same rules should also be applied to these more sensitive types of obligors. The indicators mentioned appear most relevant if thinking of debt of households and loans to smaller companies. They lack clearly defined indicators derived from financial markets that would be much more relevant to larger obligors. The current references to market movements are vague, and thus fail to achieve harmonisation. It would be helpful to e.g. define a certain percentage of losses in share value over a relatively short period of time as a good indicator of potential default (which according to the draft guidelines now need only be considered when fair value in the profit or loss account needs to be reassessed under accounting rules). Rising CDS values would be another good and clear indicator, or high implicit interest rates of bonds traded in the secondary markets, as seen for instance when Fortis or RBS or AIG or Lehman failed, or when Greece defaulted on its original bonds by restructuring those bonds held by private sector banks, insurers, pension funds and consumers.

The macroprudential repercussions of banks being forced to start increase their financial buffers for larger numbers of small obligors or for the potential default of one or more systemically relevant obligors also do not appear to have been considered. Even though the lack of macroprudential

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awareness is a design flaw of the CRR-article, the guidelines could have helpfully added text on what to do when a systemically important private or public sector entity shows such signs, or if a specific industrial sector or the whole of the private sector in a member state starts to show signs of stress. In that case supervisors and central banks need to be informed of such signals, and in turn should be able to instruct banks to act both in line with their legal obligations to assess indicators of non-payment, but without doing systemic damage. For instance by orchestrating a joint response so that all banks prepare in the same manner (by acknowledging the potential for default of e.g. the USA under a political shutdown, Greece when the first bail-out appeared to be too optimistically structured, or any troubled bank about which rumours swirl in the financial markets). This same point applies to the proposed rules for keeping an obligor nominally in default – even it has started to pay again – to check that the default indicators have indeed permanently receded before allowing the bank to bring down the required level of capital again. As currently formulated, for instance the fact that the ECB accepts unsecured sovereign bonds of Greece again as collateral, or that a conditional new bail-out programme was politically agreed, would not have meant that the commercial banks of Greece could have brought down their increased capital levels for Greek sovereign debts. Such ECB actions are not mentioned as an indicator that all troubles are permanently over. That also applies to the question whether the USA can return to non-defaulted status quickly when a last minute deal on a budget or higher debt ceiling is agreed.

Perhaps a strict application of the law on systemically important obligors is not the intention of supervisors, and may not have been the intention of some members of the Council of the EU as co-legislator. The CRR definition of default nonetheless applies to all sorts of obligors, not only to those that are relatively irrelevant. A bank or supervisor that blatantly ignores indictors of default, and fails to increase the CRR-mandated minimum of capital in a timely manner sets itself up for liability. It thus may be good to give more clarity on the content of the legal obligation of banks and supervisors, instead of relying of regulatory forbearance and/or politically sensitive application of the CRR rules to avoid amongst others macroprudential consequences of a too strict or too late application of the definition of default.

Also see:

- Art. 110.4, 127, 178, 506 CRR and art. 101.5 CRD IV Directive.

- Art. 154.1 and 154.7, Annex VI part 1, chapter 10 (§61-65), Annex VII part 4, chapter 2.1 (§44-48) Recast Banking Directive 2006/48/EC (as replaced by the mentioned CRR provisions)

- EBA, Consultation paper, Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013, EBA/CP/2015/15, 22 September 2015. {link: http://www.eba.europa.eu/documents/10180/1198203/EBA-CP-2015-15+%28CP+on+GL+on+the+application+of+the+definition+of+default%29.pdf }

- ECB, Public consultation on a draft regulation of the European Central Bank on the exercise of options and discretions available in Union law, November 2015, article 4. {link:

https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/reporting_options.en.html }

- EBA, overview of options and discretions. {link: http://www.eba.europa.eu/supervisory-convergence/supervisory-disclosure/options-and-national-discretions }

-EBA, CEBS's technical advice to the European Commission on options and national discretions, 17 October 2008, amongst other option 70, 113 and 151 (disclosure: at the time I was the chair of the relevant working group). {link: http://www.eba.europa.eu/documents/10180/16106/2008-17-10-Final-Advice-on-options-and-national-discretions.pdf }

- EU Banking Supervision, Chapter 8 {Theissen, Roel, 2013}

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