BNP PARIBAS

EU Transparency Register Identification Number:
78787381113-69

Paris, 22 January 2016

EBA Consultation on Guidelines on the application of the definition of default (EBA/CP/2015/15)

BNP Paribas Response

BNP Paribas welcomes the opportunity to comment on the EBA's Consultation on the application of the definition of default. Please find hereby our main comments on this consultation and our detailed feedback within our answers to the EBA's questions.

As a foreword, we would like to underline that we appreciate the efforts of the EBA to seek after the enhancement of convergence across institutions and jurisdictions for the key concept of default. The key message we would like to put across is that this new definition should leave some room for expert judgment: indeed, this new definition may in some cases place some counterparties in default for inappropriate reasons – i.e. not linked to credit assessment – and thus disconnect the default status from the economic reality and the creditworthiness of the counterparty. This may lead to unintended consequences whereby, in order to comply with the new definition, institutions would have either to change their credit process and allow lending to customer in default or stop lending to such clients. The first point would have some very material implications on the use test, while the second point could have very damaging consequences on the economy. By way of example, an obligor may be declared defaulted not because of financial difficulties but in reason of an inadequate definition of default (technical default due to commercial disputes, sale of a credit with a discount) that could hinder this obligor to obtain funding sources.

The risk of disconnecting the notion of default from the economic reality of the counterparty is acute, with a "regulatory default" which would not be considered as such for the credit decision and thus harm the use test of the Basel framework.

In addition, the EU commission is working on a European label of "Simple Standard and Transparent (STS)" securitisation. Among the criteria contemplated for this label, is the requirement that no exposure in default should be included in the pool of securitised exposures. A definition of default that would cover exposures sold or bought with a discount above a certain threshold or for which a commercial dispute exist, may make a wide range of instruments ineligible to securitisation transactions, despite the good creditworthiness of the related counterparties and contrary to the perceived objectives of the Capital Market Union. 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 and that the STS framework overall requirements effectively ensure its resilience.

We remain at your disposal for any further information or discussion.

Yours sincerely,

Jean Jacques Santini

Head of BNP Paribas Group Public and Regulatory Affairs

I- Answers to the questions

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: as it stands, all non-payments unrelated to reasons of a lack of creditworthiness would be considered as defaults except for the two cases quoted in the Consultative Paper.
This would be a significant change compared to the current practice on non-retail activities where this restrictive definition is not applied and expert judgment is used to determine whether a past due situation is pertaining to technical default or not.
It is critical that the new approach sets out a much wider definition of the eligible technical defaults situations. Indeed, situations can occur, resulting in past due exposure more than 90 days, but are not due to a credit deterioration of the counterparty. Below is a non-exhaustive list of such situations which should also be included in our view in the definition of technical default:

- Commercial disputes with a customer in the case of the leasing activity when the quality of the delivered product / service is contested.
- Commercial disputes in the case of the factoring activity. For example, when there is a contestation, litigation or discussion on the invoice between the client and the debtor. This furthermore will often be unknown to the factor and could have harmful contagion effects. Additionally, commercial disputes in the factoring sector are generally not solved in a court of law: the reality of the day-to-day commercial practice means there is generally a more informal agreement directly between the debtor and the client which can result in a different due date of invoice to that originally envisaged and/or a payment postponement and/or redemption through a client credit note.
- Commercial dispute on a SBLC could place 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 the participating EU banks would place the corporate in default, resulting in a possible limitation of the customer's access to the credit).
- Call of suretyship where the suretyship contest the legitimacy of the call which entail a past due situation (case of unfair/abusive claim).
- Long administrative processes to provide payment authorizations. For example, French "Local authorities" have a payment practice of more than 90 days. Besides, transfers of loans between local authorities usually require a timespan longer than 90 days. The current French "territorial reform", consolidating a number of "regions" from an administrative perspective is thus likely to result in numerous transfers of loans and payment delays in the coming years.
- Logistic process issues for Energy & Commodities financing or generally for Trade Finance: all of these reasons may lead to delivery delays. For example, merchandise blocked at customs, prohibition on entering or leaving ports, strike actions…
- Disputes regarding the amount or the nature of collaterals in case of margin calls (detailed dispute resolution procedures generally exist in standard collateral documentation, such as EMIR – Portfolio Reconciliation and Dispute Resolution provisions).

- As for asset financing long term loans, amendments/waivers or consents are often requested due to – for example – a lack of customer responsiveness, maintenance check of products, reality check of the financing according to new market conditions. The expert assessment as to the existence of a default is therefore essential on a case by case basis.
- In general, cases of force majeure (environmental disasters, legally imposed measures, riots, strikes, wars…)

In addition, commercial disputes may be solved after a number of years, meaning that the borrower could remain in default during this period, even without going to law court.

Another risk of this too restrictive definition of a technical default is to affect the pertinence of internal models. This may also lead to an increase of credit allowance at constant perimeter in terms of activity and risk profile.

Another point is the lack of judgmental evaluation in the proposed definition: if we agree that institutions shall converge in terms of definition of default, this shall be noted that banks are not at the same level in terms of IT monitoring and big data management. Some institutions have already developed, in accordance with their supervisors, monitoring systems sufficient to their business as usual.
As already recommended by IIF-IRTF, it would be more risk-sensitive to keep a flexibility and expert judgement for numerous specific cases.

However, we deem that this approach might be acceptable for an application to the retail activity where a more mechanical approach seems more adapted.

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.
In a nutshell, we advocate:

- to clearly decorrelate the debtor risk from the client risk, seen the inherent difference in nature, to avoid introducing artificial default rates not linked to the debtor creditworthiness,
- to trigger a default on a debtor based on a default on client, or to introduce a maximum 180 days observation period for a debtor default, out of any technical default,
- to introduce a judgmental evaluation of relative relevance of risk triggers when the same counterparty is both client and debtor (of other clients) in case of without recourse operations if relevant in capital requirement computation,
- to align the several official texts, by focusing on the risk beard by our client rather than on the risk on the debtor, seen the contractual relation existing between the factor and the client, together with the absence of relation between the debtor and the factor (invoice excepted).

We would like to underline that such considerations shall be shared with all activities related with purchased receivables.

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 much as possible the accounting framework.

The stage 3 of IFRS 9 includes exposures that are credit-impaired (e.g.: if significant financial difficulty of the obligor, breach of contract, concession granted due to financial difficulty, probable bankruptcy of the borrower etc...).

However, while defaulted exposures would generally 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 CP but also for some technical defaults (see answer to question 1 above).

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

Indeed, beyond the IBNR which is a current notion of IAS 39, it should be stated clearly that the IFRS 9 stage 2 should not be considered as an indication of default. This is all the more important that the § 178.3 b) of the CRR which mentions "a significant perceived decline in credit quality" as an indication of unlikeliness to pay might be misleading and wrongly analogised with the stage 2 of IFRS 9 ("significant increase in credit risk"). We would request then the EBA to clarify whether our understanding of considering only stage 3 assets as defaulted is correct or not.

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 inside the Group. This is over-restrictive and does not reflect the reality and would have the following unwilled effects:

- Threshold/cliff effect: the 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 and this could incur an actual payment default.
- In a deleveraging period or for portfolio management purposes, it may incite the sale of only good quality assets to avoid a defaulted categorization of the other assets issued by the counterparty and kept in the balance sheet.
- A bank may sell credits for another reason than the anticipation of a decrease in credit quality of the issuer. A decision to sell participations in loans on performing clients and with 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

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.

Moreover the fixed threshold [5%] does not take in account the maturity of the credit obligation: Mechanically the impact of a credit deterioration will not be the same on the price of a 1 year and a 10 years obligation.
In addition, a fixed threshold does not take the impact of the volatility of spreads during the periods of stress : During the 2008 crisis on the credit spread, the volatility of CDS spread had led to huge increase in credit spread while no default have occurred on those large corporates.
During the EBA's public hearing, a participant has proposed to use CDS spreads or the stock's market value to assess a possible default. We think that both proposal are not appropriate indicators of the materialisation of defaults and would introduce inappropriate volatility in the definition of default.

We deem that an expert judgment should be included in this appreciation.
We think that this calculation could be instead considered as another criterion of unlikeliness to pay but to be associated with other indicators.
Finally, this calculation could also be incompatible with the approach proposed in the distressed restructuring chapter: a default could be triggered by a discounted sale of obligation, while a distressed restructuring respecting the 1% rule would not trigger the default of the same counterparty.

We understand that the EBA, with this proposal, wants to prevent credit institutions to sell assets before they become defaulted in order to avoid an impact on the internal PD. We disagree with this EBA assumption and would like to propose an alternative formulation for this situation in order to avoid putting in default all the counterparties for which a discount is higher than 5%. We thus suggest the EBA to replace § 32 by the following paragraph:

"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."

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 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 for question 4, we think that basing the definition of default on the price of an asset is not appropriate.
It would have indeed a pernicious effect in the sense that banks will be incited not to purchase discounted assets in order to avoid to put the borrower in default , this would be particularly an issue if institutions have already exposures on the issuer.
From an economic standpoint, we cannot miss the fact that banks act as intermediaries on the markets and that purchased receivables management is an integral part of the banking sector's activity.

Thus we 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 the credit risks, nor with the notion of "use test".

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

Borrower: (anonymized 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 accordingly with 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.

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 the multiple default cases by imposing a probation period. However, this 3 months period might be too long in certain cases and would require important adaptations of the current rules regarding the 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 deem that the rule should be rebuttable 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 the distressed restructuring. Thus an obligor could be in default because of a distressed restructuring, while note being past due thanks to the restructuration.

A possible compromise would be to flag the client as "NPE non defaulted" during the probation period, identifying financial difficulties occurred in the past but not penalizing the client while it repays its debt. Instead of prescribing a probation period, another solution would be to require multiple defaults to be regrouped when modelling/back-testing.

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 and do have, depending on our subsidiaries, different levels of application of the definition of default for retail exposures. Our retail activities strike not only transactional relationships with our clients but also fiduciary and middle/long-term relationships with them.

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 is not clear cut, e.g. when a mortgage payment is automatically assigned on another credit facility. Some banking arrangements stipulate that some overdrafts can be indeed automatically compensated by cash from another account. Sometimes, these accounts are managed by the same Group but by different legal entities. In many cases, these different legal entities do not have at their disposal common IT systems or scoring processes.
We would favor a contagion effect to be managed at a legal entity level and not at Group consolidated level.
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.

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

The EBA proposes that if a default occurs on a joint exposure, then all other exposures on these obligors (taken individually or jointly) shall be considered in default. However, we do not support such a mechanistic and automatic process which lets no place for judgmental review and expert opinions.
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 1€).

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

We agree with these requirements which we do already meet.
It seems to be already in line with CRD 4 requirements.

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

II- Other comments - Areas requiring further clarification

- **Unlikeliness to pay criteria**

As an additional point, another indication of unlikeliness to pay seems quite constraining and not economically justifiable: "(c) the borrower's overall leverage level has significantly increased or there are justified expectations of such changes to leverage". This would be indeed counter-intuitive to be penalized for financing a counterparty which has improved its credit quality.

- **Daily basis counting past due**

In paragraph 19 and 91, it is stated that the past due count must be performed on a daily basis. This type of count gives a potential high volatility to the results and, for factoring in particular, it can generate a relevant IT burden to account correctly exposures on clients / debtors. We would instead recommend a calculation on a monthly basis and at the end of month only.

- **FIFO vs LIFO methods**

Further to the reading of the guidelines, it is still unclear to us whether the repayments of a defaulted counterparty shall be assigned to most recent past due amounts or, on the contrary, the oldest ones. The qualitative questionnaire has revealed that, across jurisdictions, there were different practices, sometimes imposed by the national supervisor. Does the EBA favour one of the approaches or does it let latitude to institutions?

- **Purchase or origination of a financial asset at a material discount**

According to IFRS 9, the purchase or origination of a financial asset at a significant discount that reflects the incurred credit losses is an evidence of credit impairment. EBA draft guidelines relate to "purchase or origination of a financial asset at a material discount". To avoid any confusion, the EBA should clarify whether the two notions are meant to be similar or not.

- **Clarification on the implementation calendar**

We understand EBA requires institutions to incorporate the new default definition into their internal procedures/IT systems and adjust accordingly their rating systems by the end of 2019. In order to meet this deadline, this leaves to institutions not less than 4 years to do the below mentioned steps in the following order:

- Year 1: incorporate the new definition in the IT systems
- Year 2: observe new defaults
- Year 3: assess the impact of this definition on rating models, in order to determine if the models should be recalibrated or rebuilt
- Year 4: recalibrate or rebuild the models. We estimate the implementation to take 12 to 24 months depending on the materiality of the impact.

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