PP ABI in response to

EBA Consultation Paper (CP) on the “Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013”

General comments

We welcome the objective of the Guidelines to harmonize the definition of default to ensure consistency of its application, transparency and comparability of risk parameters between banks across the Member States.

1) Time needed for implementation

The impact of the proposed definitions on financial institutions will vary depending on the extent to which the current approaches deviate from the proposals.

However, given the envisaged significant impact on substantial part of institutions, we would like to stress **that sufficient time needs to be granted** to change all the different **operative procedures** and to enable **banks customers** to became used to the new rules, sometimes very strict compared to the current ones. In addition to the **previous remarks, common to all banks**, the **IRB banks** needs to have sufficient time to enable the **recalibrations of models and banks internal systems** and also to factor in the time required for obtaining **supervisory approval** of the banks’ internal models.

In order to **minimize the operative impact** it is important to **synchronize** the entry into force of the new definition with the **IFRS 9 standard**. The new rules on the definition of default should therefore not enter into force before the mandatory application date of IFRS9.

2) Application method of the new proposals

We understood that EBA is aware of difficulties to apply the proposals retrospectively. **Adjusting historical data** to the proposed application of the default definition will be challenging in terms of required cost and time, if not impossible due to unavailability of the data. There are cases in which the **retrospective application of the definition of default is not completely correct in principle**, as it occurs for the distressed restructurings and sales of credit obligations. It is indeed likely that different considerations would have been made when outlining the restructuration plan or the sale conditions, if the definition of default had been different. Through statistical adjustments on default, in addition, the **level of approximation also on other parameters could be very high** (it is difficult to predict a fictitious default, not detected in the procedures and not treated as such. This would affect PD models predictability, with potential distortive effects on LGD and EAD). An approach based on generic **best estimates following the new rules,** opens the door to a high degree of **inhomogeneity.** At the same time also **parallel running** is almost unviable from an operational perspective. Therefore, even if from a certain point of view the prospective applications seems preferable, we would not say that the new definition should

be applied necessarily only prospectively, but our position is that **it should be carefully discussed how to balance a need of with some constraints it has.**

EBA should give some guidelines on this (following some criterions already issued for external data not compliant with the new definition). In this respect **ABI asks EBA for a strong collaboration with the industry** and is at EBA disposal for some ad hoc meetings in order to come up with a feasible proposal and with rules able to guarantee a level playing field in the migration to RWA deriving from IRB models based on a uniform definition of default.

3) Materiality thresholds

Materiality thresholds, compensation of past due amounts and technical defaults are issue strictly interconnected.

While materiality threshold was subject to separate consultation, we have noted the inclusion of a scenario in the **QIS that assumes application of an absolute limit 200 EUR for retail exposures and 1000 EUR for non-retail exposures and a 2.5% relative limit for non-retail exposures.** This means that, **at least for retail exposures the new proposal is stricter than the previous one** that was challenged by majority of the respondents to the consultation, requesting a more relaxed rule. The concerns already discussed in the previous consultation are now even deeper and are exacerbate by the new provisions on technical defaults/past due (see response to question 1).

While we appreciate that some of the industry comments in response to the consultation on materiality threshold have been reflected (with particular reference to the breach of both absolute and relative thresholds to trigger default calculation), we believe that the 2.5 % relative threshold is still low. In line with our previous comments and of those of the EBF**, we ask for a 4% threshold, both for retail and not- retail.** The macroeconomic and credit risk management ground for this request can be found in our previous position paper on this topic.

Introducing only an absolute threshold for the retail exposures risks undesirable impact in particular on SMEs portfolios.

We note that QIS (par. 3.3 "Part 2: Quantitative questionnaire – policy options - 3.3.1 Materiality threshold", letter d) says that *"the counting of 90 days (or where relevant 180 days) begins at the moment this amount breaches the threshold".* Wording of this specific section suggests that the counting of days past due starts only at the moment when the amount past due breaches the materiality threshold. We therefore **ask for confirmation** that this interpretation is correct. Consequently, that will mean that **an exposure which is materially past due has to be considered defaulted only after 90 days of continuing past due status**.

We would like to stress that the approach proposed in the QIS (paragraph 3.3.1) may be particularly detrimental in **factoring operations** for exposure to assigned debtors referred to in paragraph 23, where a lot of past due invoices are often present for each debtor by reason of the common payment practices in trade relationships. In fact considering all amount past due in order to verifying the breaching of the threshold in order to identify default after 90 days of consecutive breach on the *thresholds would certainly bring to recognize most of the debtors as defaulted, even in the absence of any invoice past due from more than 90 days.* Should this approach be confirmed, a clarification and a relief for these exposures should be provided, e.g.

by **conditioning the identification of default to the presence of at least one invoice consecutively past due for all the counting of the 90 days.**

Moreover, further specifications about the counting rules of days have not been still stated. In particular, it is not clear if reset, **suspend or continue the counting of days in case the materiality threshold is no more breached before the 91 day.** In addition, more details about which conditions need to be satisfied before to return from the past due status would be appreciated (e.g. the **reduction of the materiality past due below the threshold is sufficient to remove the past due classification or the entire past due amount needs to be paid?).**

4) Compensation of past due amounts with unused credit lines

We ask for the introduction of a provision that will allow compensation of past due amounts with unused general credit lines for the same debtor. The possibility to compensate would allow avoiding considering as defaults the cases where a customer has past due amounts on a line of credit and available margin on another one. In such situations, the anomaly in the payment structure is likely to be due to **a non-optimal management of the position**. The possibility to net the past due exposure with the available margin would avoid this situation, and moreover would be more in line with the counterparty level approach followed by this consultation.

5) Specific treatment for public entities

Low thresholds as those proposed by EBA give raise to concern about the exposures of institutions to public administration and government institutions that are in some instances obliged to postpone their payments for administrative reasons. **We believe that the default of a public administration requests further considerations and evaluations.**

During the **public hearing, EBA** has indicated that it will be proposing **a specific treatment for public institutions on the evaluation of unlikeliness to pay**. We do believe a **similar exceptional treatment** should be introduced for the **past due trigger for default**. This we believe would be justified given the specificities of the trade debts of the public administrations, where payments habits vary amongst Member States. In some, the average past due day exceed 180 days while the actual risk of losses is very limited. We ask EBA to **consider the introduction of a waiver that would allow the institution to suspend the counting of past due days if the debtor (being a public administration) makes a payment on at least one of its past due exposures.**

6) IFRS 9 considerations

The new accounting framework (IFRS 9) should be taken into account in developing proposals for the definition of default. **So we underline the importance of having the implementation of the new default definition not before the go live of IFRS 9 accounting principle.**

In fact it would be overly burdensome for us from an operational perspective to adapt the new definition of default to current accounting practices and shortly after to the revised IFRS 9 principle.

7) Frequency of Past Due calculation

While we understand that EBA's objective is to identify the default at the day when it occurs, for some banking products such as mortgage loans, the determination of default is performed at the end of each month. The required change to **daily determination needs to be adjusted and simplified** to avoid significant increase in the complexity of the implementation.

8) Probation Period

As more precisely described in answer to question 7, **we ask that counterparties being classified as defaulted could return to non-default status as soon as the obligation is paid in.** The three months period should therefore be eliminated as mandatory provision. This is particularly crucial for default trigged by past due. If left unchanged there might be unintended impact on **credit risk bureaus** and on **relationship with costumers** registered on them. Customers, specially retail one, will probably not understand and easily accept a rule that marks them as defaulted debtor after the obligation is paid (considering all the related consequences on credit application).

9) Past Due criterion in case of variation in the repayment schedule

According to paragraph 17 and 18 of the Consultation Paper, if the law or the credit arrangement explicitly allow the obligor to change the schedule or suspend/postpone the repayments and the debtor acts within the granted rights, the counting of days past due shall be based on the new schedule.
We deem that the final Guidelines should specify that the **counting of days past due shall be based on the new schedule** not only if the review in the repayment conditions is allowed by the contract or by the law, but **also in case it is due to a renegotiation of the credit arrangement performed by the parties.**

10) Examples of default calculation

We ask EBA that in the final draft of the Guideline some examples are introduced in order to better clarify the mechanism regarding the compensation of past due amounts, the counting of days past due and the computation of the sum relevant for the materiality threshold.

Response to the specific questions of EBA

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.

Wording of Section 3.2.2 (first bullet point on page 7) and section 5.1 D c (pages 50-52) seem to suggest that only data or system errors caused by the *institution* are covered in the definition of technical default as opposed to including data or system errors caused by counterparties.

In the modelling of larger customers it is expected to be rather common that payment delays not caused by financial issues would exceed the materiality threshold. If defaults that are a result of data or system errors of the counterpart are not regarded as technical defaults, modelling of PDs for large corporates will turn into a matter of modelling probability of errors in customer's data and payment systems. With the strict interpretation of a technical default suggested by EBA, the most relevant risk driver in Large Corporate portfolios would be the size of the company. **We believe that payment delays not related to deterioration of the credit quality of the counterparty should not lead to default.**

We do not share the view in paragraph 20 that the classification of the obligor to a defaulted status should not be subject to additional expert judgement. Expert judgement has an important place within credit risk management and should continue to be used. **Situations may occur that will result in past due exposure of more than 90 days, however not due to a credit deterioration of the counterparty.**

For example:

- In leasing business lines, a client could suspend payments not only for a difficulty to reimburse the bank but also for a management decision if a dispute occurs on the leased good (e.g. regarding the quality of goods).
- The same might occur in factoring business. In case of a controversy on a supply, litigation or discussion, the debtor can decide not to pay the invoices, although his creditworthiness is unchanged. This furthermore will often be unknown to the factor and could lead also to damaging contagion effects (please see also our response to question 3 below)
- Commercial dispute on a SBLC (Standby Letter of Credit) 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 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).
- Logistic process issues for Energy & Commodities financing or generally for Trade Finance leading to delays in the delivery. For example, merchandise blocked at the customs, prohibition on entering or leaving ports, strike etc.
- Disputes regarding the amount or the nature of collaterals 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. The expert assessment is essential.
- Specific cases of sovereign counterparts, for which default may be assessed at political level.
- Cases of force majeure (environmental disasters, legally imposed measures, riots, strikes, wars…).
- Payments made by debtors to a factor for certain ceded invoices and not yet registered on the right account due to difficulties in the payment reconciliation process.
- Invoices due but not correctly and promptly dispatched to the debtor by the seller.

Some commercial disputes can last for several months or even years meaning that borrower would stay in default during the whole period. We believe it is important to avoid capturing defaults related to exposures that are disputed or waived or that are not related to the decrease in the quality of the credit risk.

In addition, we strongly ask to underline that in case of a new and **wider definition of default** (defined among others by way of new and stricter rules on technical default), **floors on the minimum level of LGD have to be reviewed or completely removed**. In addition, some adjustment will be needed to the general calibration of standardised approaches.

Finally, at least for high default portfolios, **we ask to have the possibility of identifying technical defaults on a massive basis rather than on a case-by-case.** With regard to the provision in paragraph 19 (requiring to considered "*the sum of all amounts past due… for purpose of comparison with the threshold"*) **we ask to introduce a provision in line with the following:given an obligor that has at least one amount past due more than 90 days, the potential amount in the "less than 15 days past due" bucket can be scratched as an addendum of the above-mentioned sum.**
In other words the numerator of the materiality threshold should be limited to the sum of the buckets "more than 15 and less or equal to 90 days past due" and "more than 90 days past due". Once the amounts migrate from the first to the second and then third bucket there will be no distortion in the past due amount calculation.

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 suggest do add the following sentence after §22: " *When the factor and the client agree a due date for the credit granted to the client, the counting of days past due shall commence from such date."*

The treatment of exposures to debtors stemming from IAS/IFRS compliant purchased trade debts within a factoring agreement with a client (i.e. where the risks and benefits related with the assigned receivables are fully transferred to the factor and the factor has exposures to the debtors of the client) should take into account that **the reliability of the due date of the invoices**

may be affected by numerous events related to the trade relationship between the buyer and its supplier.

In such cases, a significant delay of the payment may occur without any sign of deterioration of the situation of the debtor. Such situations may originate from contractual provisions or also from informal communication and exchange between the buyer and the supplier.

In such situations, we believe that **a relief should be introduced by way of a rebuttable presumption on the automatic classification as past due of trade debtors or of a suspension of days past due counting** when the factor is aware of these events, regardless the degree of formality. These occurrences shall however trigger an analysis of the debtor's situation in order to assess possible indications of unlikeliness to pay.

In particular, when the buyer disputes a receivable (e.g. receivables not existing at all or just partially existing, commercial supply not regular or different to the agreements, etc.), **the amount or even the very existence of the invoice may be challenged**. It is very uncommon that disputes are brought to a court. While disputing parties are usually try to settle the dispute **outside the court**, the process can **nevertheless be time-consuming and exceed the 90 days**: therefore a relief should apply whether or not the dispute has been put forward to a court. Indeed, from a risk perspective, disputes, as well as discounts, deductions, netting or in general credit invoices issued by the seller are not in the field of default risk but rather in the field of dilution risk. Hence, that disputes are not a signal of default risk on the debtor and therefore disputed invoices should not be considered past due. Those events should rather be classified within client risk, since they are not covered by credit insurance (and consequently do not represent debtor risk) and since, if they occur, the corresponding amounts are debited from the client account and finally generate client default if they are not reimbursed before 90 days. **Therefore, dilution risk should be treated according to art. 230 of the GL10 and not represent a source of default risk on the debtor.** The opportunistic use of disputes in order to hide financial difficulties could easily be detected through the analysis of the debtor's situation triggered by the occurrence of the dispute.

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

We agree with the proposal and we underline the importance of having a harmonised application of the definition of default and clear rules for the treatment of SCRA.

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

While we agree that selling of a credit obligation resulting in a loss due to fall in credit quality could be an indication of default, we consider the proposed threshold of 5% too low given that even small deterioration in credit rating or changes in interest rate might lead to 5% impact on the market value of an asset. **We would therefore recommend to increases the minimum threshold to the level of 10%.**

The recent history 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**. In consequence, the bank may cease granting facilities to the obligor and this could trigger an actual payment default.

Credit obligations could be sold 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

A sale price of an asset, which is the fair value, will include other elements besides the credit quality such as liquidity premium; general changes to market conditions, etc and it may not always be straightforward to distinguish which part of the economic loss is related to the deterioration in credit quality. **We would therefore suggest to set up objective criteria to identify sales of credit obligations not related to credit risk.**

It also has to be taken into account that in case of **sales of credit obligations 'en bloc'**, a discount is usually applied compared to one to one evaluation (in order to conclude the deal earlier) with no link to the real risk of the block.

We would propose that the sale of credit obligations is considered as an indication for unlikeliness to pay but should be associated with other indicators and not as a stand-alone criterion.

Furthermore, it is opportune to explicitly identify the different effects of the proposed measures in term of accounting, capital requirements and impact on the estimation of the risk parameters for Institution that use the IRB Approach.

Finally, we would appreciate a clarification by the EBA on **whether securitized credits have to be considered within the "sale of credit obligation" category**.

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?

We would advocate the discounting with the "original effective interest rate", in line with the IFRS 9 (5.4.3).

Considering the **1% threshold** for the diminished financial obligation, we believe the threshold is set at a **too low level**. In our view, the relevant measure for recognition of default should be **set at a level, when the new cash flow (NPV) would no longer be adequate to cover the book value of the obligation, regardless of the decline in NPV**.

In addition art 178 (3.d) of CRR considers *"material forgiveness,..., of principal, interest or, where relevant fees".* The proposed threshold seems not to be consistent with the above mentioned materiality criterion and has therefore to be set at a significantly higher level.

We would also **see no need for specifying additional indicators to be considered for identification of default** if the net present value of expected cash flows on the distressed restructuring arrangement is higher that the net present value of expected cash flows modifications.

Concerning the formula for calculation of the diminished financial obligation (DO), it is not clear whether the cash flows include the **expectation of recovery**. If they do not take into account recovery expectation, the threshold would not make much sense as the new restructured loan could include a reinforcement of the collateral value which might mitigate (partially or totally) the diminished financial obligation measured with the proposed formula.

In addition, the formula provides possibility to hide a distressed situation by sufficiently extending maturity and maintaining an equivalent NPV of cash flows. It is also not clear if **the two NPV parameters only include the future contractual cash flows or also PD and LGD associated to those cash flows in each moment.** In the case of latter, the approach would suffer from a **circularity problem**. Some restructuring would not be considered as defaulted under the proposed formula for instance when the credit obligation is turned into a PIK loan (payment in kind) with capitalized interest during the period. The proposed formula gives an economic loss of 0.

Finally, we would like to underline that the **concept of distressed restructuring** does not apply in case a revision of the conditions is allowed by the contract (e.g. embedded clauses) or by specific laws (e.g. moratoria issued by banking association/government) or to commercial renegotiations (e.g. change of interest rate for commercial purposes or alignment with current market practices).

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?

We agree if CP (paragraph 46 and paragraph 47, letter g) has the same meaning of the IFRS 9, Appendix A "Defined terms" that states "Evidence that a financial asset is credit-impaired include observable data about the following events: (...) f) **the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses**".

If not we disagree. A material discount can be the result of other than financial distress such as general changes to market conditions and a result of negotiations e.g. settling other transactions. Therefore it seems unreasonable that the discount as such should be an indicator of unlikeliness to pay. Such assessment is normally a part of the due diligence of the asset to be bought, to be able to establish a relevant value/price of the asset.

Introduction of rules linking default to the price of purchased (or sold) assets could in effect lead to disincentives for banks to purchase/sell assets at discount to avoid putting its client in default (if a bank already has an exposure to the issuer). This would have negative effect on the

role of the banks as intermediaries on the financial markets. Purchased receivables management is an integral part of the banking sector's activities.

In our view, default should be triggered only for reasons that are directly linked to the credit risk of the counterparty.

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 believe the institutions are best placed to recognize when a customer is no longer in default and **we consider the set probation periods inappropriate**. Any probation period from default to non-default status is inconsistent with what is set out in Article 178(5) where it is stated that: *"If the institution considers that a previously defaulted exposure is such that no trigger of default continues to apply, the institution shall rate the obligor or facility as they would for a non-defaulted exposure.*

Also, under IFRS 9 favourable changes in credit risk should be recognised symmetrically with unfavourable changes in credit risk (IFRS 9 BC 5.210). **By applying a probation period, financial instruments would move into default quicker than back to non-defaulted status**. This can result in exposure being classified as defaulted but not credit impaired under IFRS 9 (bucket 2 exposures) or the exposure would be classified as defaulted and credit impaired (in bucket 3) but with no loan loss allowance which is contra intuitive.

The suggested 3 months' probation period is considered too long in relation to both large corporate exposures and retail consumers in particular when applied together with the strict definition of the technical default as proposed in the CP. In case of retail and SME customers, payments are not always fully automatized by systematic debit of the customer's account: **a delay in payment does not necessarily mean a deterioration in the credit quality of the borrower especially if the cure period is short (less than 30 days)**. Delays in payments of large corporates may be caused by systems or data errors. Such defaults would not necessarily mean a deterioration in the credit quality of the borrower especially if the cure period is short (less than 30 days).

We ask that in such cases, counterparties being classified as defaulted could **return to non-default status as soon as the obligation is paid in.** The **three months period should therefore be eliminated** as mandatory provision. This is particularly **crucial for default trigged by past due.** If left unchanged there might be unintended impact on **credit risk bureaus** and on **relationship with costumers** registered on them. Customers, specially retail one, will probably not understand and easily accept a rule that marks them as defaulted debtor after the obligation is paid (considering all the related consequences on credit application).

In the final draft of the Guidelines, having regard to Article 59 of the Consultation Paper, it is opportune to specify **which repayment suspensions shall be considered as a "grace period".**
In particular, if a restructuring arrangement provides a temporary suspension of the sole interest share of the loan, it is not clear if that suspension shall be treated as a grace period, considering that the principal share of the loan won't be suspended.

Similarly, should a defaulted client of a bank be bought by another client of the bank (client B) that is not in default, the exposures of the client B should not be considered defaulted if there is no decrease in the credit quality of client B (due to the acquisition). The remaining unlikeliness to pay should be the decisive criteria. Depending on the portfolio specific characteristics, there might be different or no probation periods.

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

To summarize our understanding of the proposed guidance:

The guideline confirms that for retail exposure, the financial institution in accordance with second sub-paragraph of Article 178 may apply the definition of default at the individual credit facility level rather than at the obligor level. Furthermore the choice should reflect the financial institution's internal risk management practice. This may imply that a financial institution in general apply the definition of default at obligor level, but for some specific types of exposure apply it at facility level.

Under IRB the financial institution is required to ensure that the risk estimates correctly reflect the definition of default applied to each type of exposures.

We supports that the credit institution may decide when to apply the default definition at obligor level and/or facility level.

Moreover, we noticed a **potential inconsistency regarding the "pulling effect"** between this **consultation paper** and the **EBA ITS on forbearance and not performing exposures**. Its application seems indeed to be binding in the 2014 EBA standards, while we deem that in the consultation paper its use is discretionary for banks. **We ask to eliminate this inconsistency.**

9. Do you consider that where the obligor is defaulted on a significant part of its exposures this indicated the unlikeliness to pay of the remaining credit obligations of this obligor?

Yes, if the default is credit risk related. We also agree that when an obligor defaults on a significant part of their exposures, the institution should consider this as **additional indication of the unlikeliness to pay but it should not automatically indicate the unlikeliness to pay of the remaining credit obligations of this obligor.** For example, a mortgage default might result in a higher Probability of Default on other credit obligations but not necessarily the default of them.

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

If a joint obligation towards an institution defaults, the individuals taking part in the joint obligations (and their individual obligations, respectively) should **not be automatically considered as defaulted.** This mechanism is even more problematic when applied to joint obligations consisting of a **large number of individuals** in which case considering all the

individuals involved in the joint obligation automatically as defaulted may not be economically justified at all.

Moreover, **the identification of joint fully liability of retail obligors** (f.e. married couple) would expose institutions to **unbearable burdens** especially when this implies ongoing updates of **dynamic information** (the marital status) difficult to obtain. As a result, we propose to drop article 85.

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

We agree. The requirements seems to be in line with CRD IV requirements. It should be ensured **however** that there is also an **alignment with the final Basel Committee Guidelines on credit risk management processed** to be applied in accounting for expected credit losses

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