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European Banking Authority
Submitted via consultation website

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Dear Sirs,

Consultation paper: Guidelines on the application of the definition of default

We are pleased to have the opportunity to respond to this consultation paper.

We are supportive of the intention to increase alignment of definition of default across the industry and we believe that the proposals in the consultation paper will help to deliver a level playing field.

The proposed guidance will widen the definition of default and as a result, more accounts will be defined as being in default for a longer period of time than is current market practice. Whilst this is likely to increase capital requirements it will stabilise the default population and reduce volatility of the capital requirement.

The consultation does not address how the proposals would impact existing IRB model parameters, particularly in relation to long-run default data. This will pose a significant challenge for IRB firms to redevelop their rating systems and to apply the proposals to their historical data.

Key observations

We support the proposal to align default definitions between Basel and IFRS9. However, we are concerned that the definition of a 'significant decline' in credit quality under IFRS9 is not yet fully defined which may lead to continued areas of misalignment with the assessment of Basel default across institutions.

We identified a number of areas in the consultation paper which we believe would benefit from enhanced guidance.

- The first area relates to the prescription of the length of a probation period which should apply to different default definitions for different products. We would suggest that the European Banking Authority provide more granular guidance on this key area.

- It is our view that further guidance would also be beneficial to clarify and align interpretation on the constitution of a material discount and the time period over which to measure a diminished financial obligation.

We are supportive of the desire to enhance the industry's usage of a single customer view across banking products. However, we are concerned that delivery of this concept is complex and is likely to pose significant challenges across the industry. As such, there is a risk that these proposals could serve as a barrier to levelling the playing field and implementation could come up at a sizeable cost to achieve compliance.

Our detailed response to the specific questions raised in the consultation paper is attached as an appendix to this paper. If you would like to discuss any aspect of our response in greater detail, please do not hesitate to contact me.

Yours faithfully,

Marian Martin
Chief Risk Officer

Appendix 1: Virgin Money's response to consultation questions

Question 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.

We agree with the proposed definitions for technical defaults, whereby data or system errors or a delay in crediting a payment by Virgin Money (VM) should not result in categorisation of the loan as in default. Furthermore, we agree that any such defaults should be excluded from the modelling and estimation of risk parameters.

We do not believe there are any further instances that should be categorised as technical defaults.

Question 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.

VM do not possess any factoring arrangements for products rated under the IRB approach and therefore do not have any comment on this matter.

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

We agree with the approach proposing that specific credit risk adjustments, resulting from either a significant perceived decline in credit quality or treatment of an exposure as impaired, should be treated as an indication of unlikeliness to pay.

We also agree that exposures assigned to stage 3 under IFRS 9 should be considered within the default definition, where the same days past due definition is used across Basel and IFRS9 models. Aligning the two approaches would be advantageous for both internal consistency and comparability of industry disclosures.

However, we are concerned by the ambiguity surrounding the definition of a 'significant decline in credit quality'. We expect this to vary across the industry under IFRS9 with no standard approach being prescribed to firms. We believe this may reduce comparability between institutions for Basel default and we would welcome further definition of a significant decline in credit quality.

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

We agree with the principle of differentiating between sales arising from a change in business strategy from those relating to a decline in credit quality of the assets. However, greater clarity would be welcomed on the point at which such assets would be treated as in default to ensure consistent application across the industry.

We do not expect this to impact VM, given our current business strategy, but this may be more pertinent for larger institutions managing multiple portfolios.

Question 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?

VM believe the specification of the interest rate used for discounting of cash flows is sufficiently clear. We think it would be more appropriate to use the effective interest rate applicable to the restructuring arrangement when discounting expected cash flows as opposed to the original effective interest rate. This would be consistent with the affordability assessment for loan restructures and is more readily available for application in our Basel models.

We would welcome further guidance on the period over which the cash flows should be discounted (e.g. 1 year, 5 years or the lifetime of the mortgage).

Consideration should be given to the time and complexity involved for firms to implement cash flow discounting for cases undergoing a distressed restructure within the IRB rating system.

Question 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?

Whilst we agree that the purchase of an asset at a material discount could be an indicator of unlikeliness to pay, we believe it is important to differentiate between those arising as a result of the credit quality of the obligor and those driven by the strategic business objectives of the vendor. Differentiation for this was recognised in reference to the sale of credit obligations in question four, therefore, we believe it is important to differentiate between these factors when considering indicators for unlikeliness to pay. Additionally, we would welcome a further definition surrounding what is meant by 'a material discount' when making the assessment.

This does not directly impact VM's business model but we believe this treatment would pose a greater issue for non-prime mortgage lenders which may have a subsequent effect on their business strategy.

Question 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 support the inclusion of a probationary period to return to non-default status aimed at reducing capital volatility from multiple instances of default. We also agree this should vary by exposure class and default categorisation to reflect different behaviour across products and treatment strategies. However, it is important that any probationary periods are well defined to avoid ambiguity across the industry.

We support the proposal to apply a longer probation period for loans undergoing a distressed restructure. However, due to VM's low default experience, we are unable to provide robust analysis to support the EBA in identifying suitable probationary periods across products and default treatments.

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

We understand the desire to achieve a consistency of treatment across products held by a unique customer but we agree with the proposed approach of being able to apply defaults at an individual account level and not at a customer level.

If however the European Banking Authority pursues the application of the definition of default at the customer level, we would advocate a greater role for credit reference agencies. Credit reference agencies already provide criteria to quantify default for a range of products and lenders across the market. Leveraging from the existing information available through the credit bureaus would provide a more sophisticated approach and aid the European Banking Authority's objective to standardise the criteria for default across the industry. We believe this would be a more cost effective option for firms to implement without compromising the benefit this would provide.

In the absence of implementing a credit reference agency solution across the industry, firms would need to apply this approach at an internal customer level, requiring the establishment of a single customer view across products. This would be a constraint for VM and other banks as the system infrastructure required to allow an aggregated view of a customer relationship over various banking products would be complex and costly to implement.

Question 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?

We agree with the theory that where an obligor is in default on a significant part of their exposures, this indicates the unlikeliness to pay on the obligor's remaining credit obligations. However, certain exclusions may apply; there will be instances where the borrower prioritises certain debts over others e.g. their secured debt over their unsecured debt. Therefore we would welcome further definition on any exemptions from default under this approach.

We would envisage that the implementation of such an approach would require significant investment in IT infrastructure to enable the various product systems to communicate for ourselves and other institutions.

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

We agree in principle with the approach to apply a materiality threshold to joint credit obligations. However, in practice this will be complex for institutions as this will be reliant on a single view of the obligor across all products. As previously noted, developing an internal approach would require significant infrastructure changes to enable interaction between all product systems. Therefore, it is important to consider the benefit this would provide to risk management across the industry against the development and implementation costs.

VM already utilise credit bureau information to provide a link across products for an individual obligor and incorporate this in our credit assessments at the point of origination and for ongoing customer management. This ensures the impact of performance on other forms of credit are considered in our assessment of risk, and subsequently capital, for our exposures.

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

We agree with the requirements on internal governance for banks that use the IRB approach. It is important for institutions employing the IRB approach to possess robust governance procedures to ensure that senior management and relevant business functions are engaged throughout the decision making processes and to ensure that impacts on the IRB models are considered throughout the business.