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Deutsche Bank's response to the European Banking Authority consultation on the application of the definition of default.

Dear Mr Farkas,

Deutsche Bank welcomes the opportunity to comment on the European Banking Authority's (EBA's) consultation on definition of default. These guidelines can provide an important tool in ensuring consistency and comparability across bank internal models. We appreciate that the 'Guidelines on the application of the definition of default under Article 178 of the Regulation (EU) 575/2013' ('the Guidelines') clarify the application of the default definition, as well as harmonising the regulatory framework with up-to-date accounting rules like IFRS 9 in addition to existing bank practices.

The Guidelines need to provide a clear, consistent and appropriate definition of what should be considered as 'material', 'significant', or 'large', in circumstances such as defining the materiality of economic losses or changes of the net present value of an obligation. It is critical for the Guidelines to provide consistent and accurate thresholds which permit a distinct identification of obligations banks have extended which are to be considered material and therefore indicate diminished credit quality.

There are two annexes attached to this letter. The first provides the DB view in response to the specific questions in the consultation paper. The second provides some general comments we would like taking into consideration.

Please do not hesitate to contact us if you have questions or wish to discuss any of these comments further.

Yours sincerely,

A handwritten signature in dark ink, appearing to read "Daniel Trinder".

Daniel Trinder
Global Head of Regulatory Policy



Annex I: Responses to specific 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.

We support the clarification of the possibility to apply "technical defaults" and support the existing proposed definition.

Technical defaults should also allow for payments that are made after the due date. This is because the counterparty may well be unable to make the payment at the time required for reasons other than financial difficulties. Additionally this is consistent with industry documentation such as ISDA Master Agreements dealing with administrative/operational errors.

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.

Generally it makes sense to distinguish between the following results of a factoring transaction: a) the creation of a payment risk solely on the obligor, which has been transferred to the factor by way of true sale; and b) the inclusion of a payment risk on the obligor as well as a dilution risk on the seller.

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

Assuming that the timelines for treating all credit exposures considered impaired under IFRS9 as defaulted will be implemented using the IFRS9 timelines, we support the approach.

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

Whilst we agree with the overall sentiment of the proposal, we believe that the following aspects need to be considered:

- In practice, it might be difficult to distinguish between loans where a loss upon sale was related to credit risk, and loans where a loss upon sale was not related to credit risk (for example a change in the bank's business strategy).
- In addition, the reporting and documentation of defaults resulting from selling all of a client's obligations is likely to raise technical challenges. This is because subsequent to the default event there will no longer be any exposure meaning there are no data sets where this information can be stored for reporting purposes.
- To evaluate the economic loss resulting from the sale of credit obligations, we suggest taking the time of repayment into account. A distinction should be made between an immediate payment of a sales price, and a sale with a deferred payment schedule agreement. A calculation can be done by using the net present values of the exposure in line with the methodology proposed for the calculation of a diminished financial obligation under chapter 40 of the Consultation Paper. In particular, considering that in many cases a decision to sell a



credit obligation with a discount will be driven by various factors, we believe that the proposed threshold of 5% to consider an economic loss as being material is very low. In order to avoid that immaterial changes in the market value of an asset are flagged as default events, we recommend increasing the threshold to 10%. We believe a 10% threshold is the most appropriate level that enables both the EBA to meet its objectives and minimises negative unintended consequences.

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 support the use of the original effective interest rate as this would be in line with the accounting framework. In this context we would appreciate if the final Guideline allowed either using the effective interest rate determined at initial recognition or an approximation of it. This would be in line with the methodology described in section B 5.5.44 of the IFRS 9 standard.

Our expectation is that in most cases, the original interest rate will be similar to the interest rate applicable at the moment before signing the restructuring arrangement. Therefore the proposed calculation is suitable to quantify the diminished financial obligation and the effect of a loan restructuring. In this context, our understanding is that in case of floating interest rates which typically comprise variable base rate(s) such as LIBOR or EURIBOR and credit risk spreads ('margin'), the cash flow calculation shall only focus on concessions related to the spread, rather than on past changes in market driven base rates. We would appreciate if the final Guidelines provide a clarification in this respect.

With regard to the proposed 1% threshold for classifying a diminished financial obligation (that according to the EBA Consultation Paper "is considered to be caused by a material forgiveness or postponement of principal, interest, or fees") we deem the threshold set at a too low level. This is because a threshold of 1% would more likely cover rounding differences in the calculation of the net present value of an obligation than represent a threshold indicating a material forgiveness or postponement of principal, interest, or fees. As per the IIF response, we believe that a 5% threshold would be a better calibration.

We agree with paragraph 43 of the Consultation Paper that "All exposures classified as forborne non-performing [...] should be classified as default and subject to distressed restructuring". We recommend explicitly aligning this with the corresponding paragraph in the EBA technical standards listing default triggers¹.

6. Do you agree that the purchase or origination of a financial asset at a material discount should be treated as an indication of unlikelihood to pay?

We agree that the purchase of an obligation at a material discount that reflects the deteriorated credit quality of the debtor should be used as an indicator for unlikelihood to pay the obligation in full.

¹ EBA ITS on Forbearance and non-performing exposures EBA/ITS/2013/03/rev1



We recommend defining the materiality of the discount by using the same threshold as that used for the sale of a credit obligation with an economic loss (see question 4). It would be logical for the determination of the materiality of a discount for both the sale and the origination of an obligation follows the same rule.

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 appreciate the proposed alignment with existing regulation such as the EBA technical standards on non-performing loans/forbearance which mandate a 1 year probation period for non-performing loans in order to reduce complexity.

With respect to the proposed probation period of 3 months for 90dpd and unlikeliness to pay, we consider probation periods unnecessary and too strict. The assessment of whether or not an obligor is still in default should be based on the institution's expert judgement. This would also be in line with CRR 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." Usually, defaulted obligors show more than one default trigger. Hence, obligors, who are in the position to repay the 3 months payment delay at one time and for which no other default trigger exists should be treated as cured without any probation period.

We would appreciate if the final Guidelines could provide further clarification on the following aspect in order to avoid different interpretations of the application of the probation period:

- How does the methodology to bring a distressed restructuring back to non-default fit into the statement in the Guideline which says "The obligation that once has been restructured under distressed conditions remains to be restructured until the obligation is paid in full" (see chapter 3.5 under 'Background and rationale' and the explanatory text for question 7). In order to avoid misunderstandings the guidelines should clarify that any previously defaulted exposure will be set to non-defaulted status as soon as no trigger of default continues to apply and the relevant probation periods have passed, irrespective of the time of repayment.

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

We generally understand the proposed approach as an option for banks. In case of retail exposures, we understand that we can either apply the definition of default on facility or on a borrower level (in case of borrower level with materiality threshold being in place).

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?

Whilst we agree with overall sentiment of the proposal, we would appreciate if the final Guidelines provide a definition of what a significant part of the exposure means. Ideally a threshold would be provided which can be consistently applied. Looking specifically at what threshold should be applied,



we refer you to our response to question one² to the EBA consultation on materiality threshold of credit obligation past due under Article 178 of the Capital Requirements Regulation.

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

We generally agree with this approach, however for portfolios where the proposed solution cannot be implemented without undue cost and burden, the final Guideline should allow for the alternative solution described in the Consultation Paper, i.e. the aggregating of individual and joint credit obligations.

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

We agree.

Annex 2: General Comments

1. Implementation

In order to align the operative requirements, it will important to harmonise the new definitions provided by the Guidelines with the final application of the IFRS 9 standard.

We foresee operational difficulties in case the new definitions need to be implemented retrospectively as it won't always be possible to change all historical data and parameters across all portfolios. This is because new definitions are not always fully comparable to default events in the past, particularly regarding the concept of distressed restructuring.

In other instances, a case by case review of all historical asset sales and asset purchases with discount would be required in order to analyse the cause for the discount retrospectively.

We therefore strongly recommend considering the operational challenges when deciding on the implementation of the Guidelines and establishing a date from which the new default definition needs to be applied. There should be no requirement to adjust historic default data retrospectively.

2. Non-Accrual Concept

We would appreciate greater clarification with reference to paragraph 24. The non-accrual concept is not an accounting treatment covered neither under IFRS9, nor to our understanding by any other European Generally Accepted Accounting Principles (GAAP). The "non-accrual concept" is grounded in the US-GAAP, indicating an unlikeliness to pay. It is a remnant of the original Basel Committee default definition being copied into the CRR. Until the CRR was introduced, the corresponding German Solvabilitätsverordnung stated that the non-accrual treatment is not relevant as a trigger for default.

IFRS requires interest income to be recognised at the effective interest rate on performing and non-performing loans (i.e. non accrual is not permissible under IFRS). Furthermore we believe that the

² Response can be found [here](#)



situation in which according to US-GAAP a non-accrual status is required, is more than covered by other trigger listed in following paragraphs, for example the Specific credit risk adjustment.

We therefore suggest removing this paragraph or limit the provision of that information to entities in countries where this information is available because of local GAAPs.

3. Definition of 90 days past due

We would appreciate an alignment of the terms for 90 days past due as there is a difference between the consultation paper ('more than 90 days past due', i.e. 91+ days) and the terms used in the IFRS 9 standard ('90 days and more past due, i.e. 90+ days past due).

We would propose to align with the term used under IFRS 9, i.e. 90 days and more past due.