**Response to EBA Draft CP on GLS on the application of the definition of default**

We welcome European Banking Authority (EBA) the opportunity to comment on the consultation paper on the application of the definition of default.

Banco Comercial Português uses the IRB approach since the end of 2010, having already implemented in the default definition some of the triggers discussed in the current consultation.

**I - General Comments**

The Bank supports the efforts made concerning the transparency of the banking system, the rules harmonization and the consistency of its implementation across the Member States.

In what refers to comparability of risk parameters there is still work to be done, as the current flexibility in the calculation of the IRB parameters drives to greater differences between banks than what was initially envisaged. Thus, efforts should be made on the standardization of the banks’ modelling options: It would limit the degrees of freedom of institutions implementing IRB, narrow the supervisor’s discretion and improve comparability across banks.

The definition of standards for the calculation of the risk parameters is paramount in this regard. It should be put in place a “closed set of definitions”, encompassing not only the default definition, but also for the calculation of default rates, LGDs and CCFs. Rules should be clear with limited self-judgment and subjectivity both for users and supervisors.

This would reduce the flexibility of the institutions in implementing the IRB and thin the discretion of the supervisor’s intervention without having a significant impact on the risk sensitivity of the IRB approach. It would ease comparison across institutions and the market’s perception on the risk profile of each bank.

Given that the definition of default is the basis of estimation of risk parameters influencing Risk Weighted Assets, Expected Loss and Capital Requirements, ensuring a level playing field in the harmonization of the default definition is critical. For that, agreeing on a, once and for all, simple criteria for determining default (eg. simply put, defined as a proportion of the total exposure) would offer several advantages:

1. It would reduce the risk of sequential changes to key definitions demanding a new round of model approvals by the competent authorities that take huge time and effort;
2. It could be used in a transversal way on the unlikeliness to pay criteria thresholds (impairment, sale of the asset or restructuring);
3. It could be easily transposed to set cross default criteria when moving from evaluating risk exposure at the facility level towards at obligor level;
4. It would be transparent, reduce subjectivity and workable.

Such general understanding of simplified criteria and procedures would mean reviewing the proposed criteria for the materiality thresholds (past due credit obligations and size of credit losses) in favour of a combination of both relative and absolute materiality threshold levels, ending with potential odd situations that could emerge from defining a default based on the breach of the absolute level though such breach being negligible at the overall exposure level, and apply the same methodology to the unlikeliness to pay criteria thresholds (sales, distressed restructuring, SCRA).

Whenever the client is still under the “probation period” any default situation should be associated to the originating position and not give rise to a multiple defaults situation. Criteria and conditions should be clear, in what refers to the “return to non default status”, ensuring an objective assessment based on automatic and simple rules.

Concerning the distressed restructuring procedures, the materiality thresholds should only be applied to customers showing financial distress, that meaning transactions with solid collaterals or being past due but that the customer has increased the level of collaterals or paid the underlying interest should not be classified as a distressed restructuring procedure. Also, the loss results from the comparison of the NPVs of the cash-flows pre and after restructuring need to take into consideration the collaterals associated to the transaction.

Introducing simple criteria and procedures would reduce time of implementation contributing for a more level playing field.

We would also like to recommend simplifying the approach to the assessment of the materiality of model changes in order to reduce the need of subsequent model reapprovals by the competent authorities. It should be taken into account that assessing the change of the definition of default of all the banks of the SSM will likely represent a very demanding task.

**2 - Response to specific questions of EBA**

**Q3. Do you agree with the approach proposed for the treatment of specific credit risk adjustments?**

We do not agree with the unconditional usage of any impairment amount assessed collectively as a sign of unlikeliness to pay for single customers included in the portfolios, bearing in mind the respective high degree of conservatism. Other proposals included in this draft RTS may provide a more precise identification of the potential default situations within the “homogenous” segment. In what concerns to customers submitted to individual analysis, a threshold should be created. It does not seem reasonable that a small impairment rate shall be treated as past-due credit for more than 90 days. The level of materiality should be aligned with criteria applied to credit sales and forborne exposures.

**Q4. Do you consider the proposed treatment of the sale of credit obligations appropriate for the purpose of identification of default?**

As per the above, the assessment of the loss materiality should be consistent across the different situations that may give rise to a situation of unlikeliness to pay.

**Q5. 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?**

As commented before, the proposed threshold for distressed restructuring is too low, particularly when new collateralization is not taken into account into the loss calculation.

The discount rate should reflect the current financial conditions. Thus, the effective interest rate at the moment of the restructuring should be used instead of the original interest rate. This would also ease complexity in situations where the original effective interest rate is no longer available.

**Q6. 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?**

The unlikeliness to pay indication should depend on the rationale behind the discount. Therefore, due to the difficulty to correctly assess these situations, we do not favour the inclusion of such trigger.

**Q7. 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 agree with the concept of a probation (quarantine) period for a defaulted case before returning to a non-default status. The probation period could be differentiated according to the nature of the trigger and the customer segment.

As per the consultation document, the credit condition of the customers should be assessed before the return to a non-default status. This assessment should be based on the observation of a simple and objective set of rules, in order to reduce the risk of different interpretations / subjectivity.

Relating to distressed restructuring, although we generally agree with the rationale of the proposed approach -a longer period-, the proposal endorses too much complexity into implementation, particularly, in IT systems. Therefore, we suggest more simple and clear rules.

Regarding the duration of probation periods, for SCRA we suggest to be used the same period of past-due credit; for credit sale, the same period of credit restructuring should be used. The duration of the probation period should be established in a clear manner.

**Q8. Do you agree with the proposed approach as regards the level of application of the definition of default for retail exposures?**

Each institution should choose the level of application that guarantees a close alignment with the internal risk management practices, in terms of customer management regarding the credit concession and recovery. Regulators should aim for this coherence. Changes could have material impacts on risk models currently implemented, namely on the calculation of PD and LGD. Any other proposal than either at facility level or obligor level may imply additional complexity in terms of IT implementation.

**Q10. Do you agree with the approach proposed for the application of materiality threshold to joint credit obligations?**

We do not agree with the treatment of joint exposures. It raises significant difficulties regarding the identification and the assessment of the degree of liability of the different intervening parties and the full scope of the exposures to be considered.

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