# Consultation response

## Draft EBA Guidelines on the Definition of Default

22 January 2016

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the EBA's consultation paper on the **Draft Guidelines on the application of the definition of default under Article 178 of the CRR.**

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

**General comments**

The definition of default has been highlighted as being one of the key areas of divergence across jurisdictions and between banks leading to significant RWA variability. We recognise therefore that resolving differences in the definition of default is critical to reducing RWA variability and improving confidence in the IRB approach. We are therefore generally supportive of the proposed guidelines' harmonisation objective.

This being said, we note that the inclusion of the "unlikely to pay" criteria in the CRR definition of default conveys a certain degree of flexibility to institutions in determining when an exposure is in default. We think that this flexibility is appropriate to cater for the wide range of risk management approaches adopted and client situations found in practice and that expert judgement has an important role to play in appropriately recognising default situations. We also wish to stress that, for the purposes of identifying defaults, credit quality related triggers must be the key drivers behind this recognition, otherwise there is a risk that too many "false positives" or non-credit related events will be included in the default status, potentially creating data instability. While the EBA has important role to play in ensuring common interpretation and application of the level 1 text, there must be acceptance amongst the supervisory community that complete standardisation of the definition of default across all EU institutions is neither desirable nor realistic.

While recognising that this is not the specific objective of the present consultation, as the point is nevertheless related, we wish to reiterate our position with respect to the default materiality threshold as expressed in our response to the EBA's consultation on this topic[1]. Indeed, AFME's view is that default should be recognised only after *both* an absolute and a relative threshold cap have been breached[2] to avoid capturing situations that are not predictive of credit risk and in order to cater for the heterogeneity of credit risk exposure levels across European countries and banks with different business focuses.

[1] Available here: http://www.afme.eu/WorkArea//DownloadAsset.aspx?id=12387

[2] With the caveat that there should be no change for firms applying a more conservative approach to materiality

Moreover, as the EBA recognises, the changes proposed in these draft guidelines, as well as in the overall IRB repair programme, will require material changes to models and significant investment on the part of firms. The overall cost of change to IRB models therefore needs to be balanced carefully against the benefits of increased harmonisation and comparability. We would welcome a clear indication from the EBA as to when and how these costs and benefits will be assessed.

As already pointed out in previous submissions, the EBA's IRB repair programme also need to be considered in light of yet further changes that may be required to firms' models given work on the IRB framework at the BCBS level. The current lack of clarity on how international developments will affect the (EBA revised) IRB framework means it is extremely difficult for firms to make model investment and strategic capital planning decisions. Certainty on the timing, content and consistency of the international and EU requirements is becoming increasingly critical.

Lastly, while we are supportive of the harmonisation objective of the proposed guidelines, we are concerned that there is risk that this objective will not be met if the issue of historical data is not addressed adequately. Changes to rules and supervisory and firms' practices are unlikely to deliver the desired reduction in RWA variability or lead to an improvement in model quality if they are based on data that has become unstable and of poor quality as a result. Our view is that most appropriate way to ensure high quality data while at the same time alleviating the burden of change for firms (and supervisors) is to apply the new requirements prospectively. Failing this, if the EBA envisages retrospective application, simplified data adjustments must be allowed and need to be considered carefully in conjunction with competent authorities in order to minimise the workload for firms while maintaining comparability between firms. Close alignment between the prudential approach to default and IFRS 9 is also desirable and will help avoid firms having to maintain multiple approaches to similar concepts. Finally, implementation dates need to be set taking into account model validation bottle necks that will inevitably occur at supervisory level. This concern should not be underestimated,

## Responses to the consultation questions

*Q1. 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 welcome the clarification of the notion of "technical default" but find the proposed definition to be too restrictive. As currently set out, it runs the risk of capturing non-credit related events.

Banking relationships extend to large complex customer groups which are characterised by multiple accounts and facilities where the potential for system and administrative errors on the customer side is increased. As such, we consider that the definition should, in addition to errors in data and systems of the institution, also reference errors that originate with the customer. Moreover, other situations outside the banks' control such as mandatory closure of banking or payment systems or disruptions to the systems as a result of environmental or societal impacts (e.g. natural disasters, civil unrest), should also be technical defaults.

Moreover, while we are supportive of introducing as much consistency as possible into the notion of technical default in particular (and default in general), the EBA should make clear that expert judgement still has an important place within the new framework and can continue to be used. Indeed, expert judgement is necessary to identify not only technical defaults but also situations where past due amounts are attributable to operational risk, or "blended events" (i.e. where there are several risk types at play) and where a decision needs to be taken as to whether it is appropriate or not to take such an event into account for credit risk requirement purposes.

This is important for instance for firms to avoid capturing so-called "qualitative" technical defaults e.g. relating to amounts that are disputed or waived. For example, in leasing business lines, a client who has subscribed a lease contract to rent a machine that does not work properly decides to suspend its payments. This payment delay is not due to a difficulty to reimburse the bank but obviously to a management decision not to do so given that the machine does not work. A commercial dispute related to the functioning of the machine may take a relatively long period to resolve, but is not indicative of a credit-related event. A similar situation can occur in factoring businesses where in a commercial relation between the factor's client (assignor) and its debtor there could be a dispute on a supply due to which the debtor decides not to pay the invoices. In this case, the disputed invoices or receivables have to be excluded from the calculation of the default because the delay of the payment is not due to deterioration of the debtor's creditworthiness but to commercial/legal reasons. Another case where there is a risk that a default could be identified even in absence of a credit event is when 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.

Lastly, regardless the values ultimately chosen for the materiality thresholds, we would welcome clarity on when the counting of days past due begins. The accompanying QIS to this consultation (see Section 3.3.1 (d) and (e)) provides this clarity (e.g. for non retail exposures, the counting of 90 (180) days starts when both thresholds are breached). This information should be included into the final Guidelines.

*Q2. Do you consider the requirements on the treatment of factoring arrangements as appropriate and sufficiently clear? If not, please provide proposals for additional clarifications.*

There are several types of products economically similar in nature to the types of arrangements described in the proposals as "factoring" but that may carry different names depending on the jurisdiction. These products should be treated in the same way as proposed regardless of the terminology and this should be made clear in the final guidelines.

In the case of factoring arrangements where the risks and benefits related to the assigned receivables are fully transferred to the factor and the factor has exposures to the debtors of the client, it should be clarified that both the absolute and relative materiality thresholds be calculated only with respect to the 90 days overdue amount. This would imply a change to the current provision which states that the relative threshold is calculated as the ratio of the counterparty total overdue (regardless of the 90 days past due indication) and the total assigned receivables: if this threshold is breached and there is at least one receivable overdue by more than 90 days, the debtor is classified in default.

Again in the case of these types of arrangements where the risks and benefits related to the assigned receivables are fully transferred, it should be clarified that if the debtor disputes the receivables for any reason (e.g. receivables do not exist, commercial supply not regular or different to the agreements, etc.) the relevant receivables should be excluded from the calculation of the default status.

Moreover, the consultation does not discuss the case in which risks and benefits have been fully transferred to the factor, but the ceded debtor has not been informed of this (if the debtor has not been notified, it is not obliged to repay the obligations on the current account reported on the receivables and any payment of the debtor in favor of the assignor can release its obligations). We would welcome clarification from the EBA of this situation.

We also ask for clarification with respect to situations where the repayment of the obligation is suspended because of a law allowing this option or other legal restrictions.

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

We welcome the EBA's proposal that the treatment of IFRS9 provisions be dealt with in these guidelines as a means of avoiding the unnecessary operational burden that would otherwise arise with several changes in close succession. This being said, there may be some exceptions where bucket 3 assets should not automatically be categorised as regulatory defaults (e.g. fraud cases).

More generally, clarification as to how categorisation of General and Specific Credit Risk Adjustments maps to IFRS9 stages would be welcome to ensure consistent application within the regulatory capital regime.

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

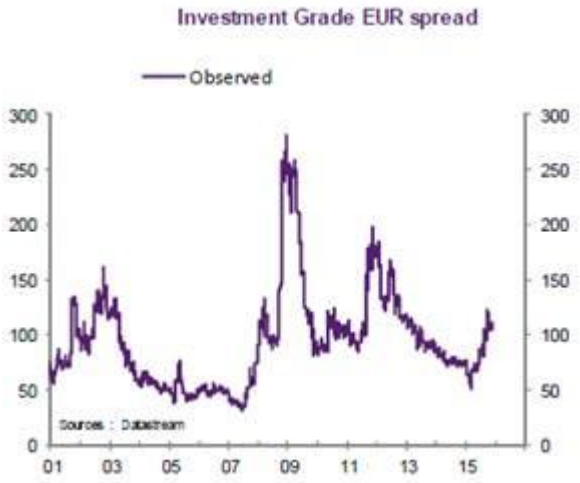
We agree with the EBA's general approach and its focus on credit-related reasons being the trigger of default identification. Indeed, the drivers of a discount may be broader than credit reasons. Beyond the examples mentioned in the EBA's consultation such as the need for liquidity or a change in business strategy, other such factors could include general market appetite in the face of changing interest rates or regulatory capital management. Credit obligation markets may also not always be liquid, and a decision to sell can cause a pricing shift not necessarily correlated to a client's creditworthiness. While some market factors may possibly be indicators of a decline in credit quality, we believe the most effective determinant remains the expert judgement of the institution and assessing the obligations and nature of the sale rather than an arbitrary threshold.

Indeed, credit spreads depend on the risk of a firm to lender loss (idiosyncratic risk), but they also reflect other risk factors (risk aversion, liquidity cost, sector risk, etc.).

For a given issuer, the credit spread varies over time even if its rating remains unchanged, and substantially higher credit spreads will have a negative impact on debt price.

The first figure below illustrates the behavior of the average corporate credit spread (investment grade) from 2001 to 2015 (source Datastream).

The average credit spread was below 50bp in 2007 and over 300bp one year later. For a 5y floating rate corporate bond issued in 2007, the credit spread increase would have caused a bond price decrease of a significant magnitude (over 5%). Yet this discount did not reflect a heightened credit risk.





The second figure (source Datastream).shows CDS spreads for American banks over a 4-year period (2012-2015). It provides another good example of high credit spread high variations which are unrelated to heightened credit risk.

Moreover, we note that, while the calculation of a threshold is straightforward in the case of individual credit obligations, the sale of portfolios is slightly more complicated as any general impairments are usually priced into the sale and should not count towards the threshold. We therefore recommend that when calculating the total outstanding amounts of the obligations subject to the sale, this should be net of any general impairments when they are accounted for in the sale price.

With respect to the evaluation of the economic loss on sale of a credit obligation, the timing of payments should also be taken into account (i.e. immediate payment in case of sale compared to delayed recovery cash flows), for example by discounting the total outstanding amount (E in the formula of §33).

We would also appreciate clarification from the EBA on whether securitised credits have to be considered within the "sale of credit obligation" category and would recommend setting up objective criteria to identify sales of credit obligations not related to credit risk.

Finally, we wish to stress that retrospective application of a threshold is not methodologically correct as it is likely that different factors would have been taken into account in the restructuring plan than those that were at the time under the previous approach (we note that the same applies for restructured exposures).

*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?*

We are in favour of the customer's original effective rate being used as the discount rate as this is consistent with IFRS9:

- For variable rate contracts, this means using the underlying rate at the moment of the calculation and therefore just before the restructuring (e.g. Euribor 3 months) together with the spread that was negotiated originally in the contract.
- For fixed interest rate contracts, the fixed interest rate negotiated in the original contract is used together with the spread of the original contract

This being said, we do not agree with the proposed 1% threshold cap, which is too low, particularly as Article 178 3 d of the CRR refers to "*material* forgiveness". A cap of 1% does not afford firms with the flexibility to effectively identify such cases.

Lastly, we wish to recall that the concept of distressed restructuring does not apply in cases where a revision of conditions is allowed by virtue of the contract or specific laws.

*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?*

No, as we are concerned that this will lead to procylicality in capital requirements and self fulfilling prophecies, including contagion across the various obligations of a client. We note that after a purchase, an asset may enter into a default situation which will be identified through the institution's regular credit risk due diligence processes and ongoing management of the institution.

We also wish to recall that for all "unlikely to pay" classifications, expert judgment must play a fundamental role.

*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?*

In general we would like to see an alignment between existing regulatory prescriptions e.g. the EBA's ITS on non-performing loans and IFRS 9.

We believe that the proposed "stage 3" IFRS 9 definition already provides a reasonable, conservative approach for the probation period for the Retail/SME portfolio. We note however the proposed analysis of the behavior of the obligor and its financial situation during the probation period – enough flexibility should be provided for to make this feasible for Retail and SME segments given the large number of obligors in these portfolios.

We also are of the view that where there has been a permanent structural cure (e.g. a large cash injection into a business), a shorter probation should be allowed to reflect the change in credit position of the obligor.

In addition, the final Guidelines should clarify:

- - what is meant by 'the moment of extending the restructuring measures', i.e. is it literally about the extension or is it just used in terms of 'granting'?
- - what exactly is meant by 'the end of the grace period included in the restructuring agreements'?
- - how the methodology to bring a distressed restructuring back to non default ties in with the statement in the consultation which says 'The obligation that once has been restructured under distressed conditions remains to be restructured until the obligation is paid in full'?
- - how are 'material payments' defined in cases where write-offs have not been performed or where there have been no past due amounts before?

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

*N/A*

*Q9. 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?*

*N/A*

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

*N/A*

*Q11. Do you agree with the requirements on internal governance for banks that use the IRB Approach?*

*Yes*

*Other issues – External data*

§57 requires clarification as it is not clear how an institution will be able to satisfy the additional margin of conservatism requirement in the case of non-negligible differences in external data that cannot be overcome through adjustments.

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