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SPECIALISED CONSUMER CREDIT PROVIDERS IN EUROPE

Leaseurope
The Voice of Leasing and Automotive Rental in Europe

European Banking Authority

Brussels, 22 January 2016

Re: EBA Consultation Paper on the application of the definition of default

Dear Sir/Madam,

Leaseurope and Eurofinas, the voices of leasing and consumer credit at European level, welcome the opportunity to respond to the European Banking Authority's (EBA) Consultation Paper on Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013.

Eurofinas brings together associations throughout Europe that represent consumer credit providers. The scope of products covered by Eurofinas members includes all forms of consumer credit products such as personal loans, linked credit, credit cards and store cards. Consumer credit facilitates access to assets and services as diverse as cars, furniture, electronic appliances, education etc. By providing access to finance to individuals and households, consumer credit supports the social and economic well-being of millions of consumers across Europe. It also benefits manufacturers, motor dealers and retailers as a key tool for their sales. It is estimated that together Eurofinas members financed over **356.3 billion Euros** worth of new loans during 2014 with outstandings reaching 827.9 billion Euros at the end of the year.

Leaseurope brings together 44 member associations representing the leasing, long term and/or short term automotive rental industries in the 33 European countries in which they are present. The scope of products covered by Leaseurope members' ranges from hire purchase and finance leases to operating leases of all asset categories (automotive, equipment and real estate). It also includes the short term rental of cars, vans and trucks. It is estimated that Leaseurope represents approximately 92% of the European leasing market and in 2014, total new leasing volumes worth **274.2 billion Euros** were granted by the firms represented through Leaseurope's members.

Leaseurope and Eurofinas support the work of the EBA in developing technical standards and promoting convergence of supervisory practices across Europe. We see the mission of the EBA as essential and very much welcome the quality of its work as well as its constant dialogue with the industry. Against this backdrop, we support the EBA's ongoing work on the application of the definition of default and its efforts to clarify the flexibility provided to institutions in this field.

As highlighted by the Authority, this work is relevant for both institutions under the Internal Rating-Based (IRB) and standardised approaches. It is particularly critical for specialised financial services providers such as consumer credit, asset finance and leasing firms both as monoline bank subsidiaries or independent and, typically, smaller scale institutions. This is because the structure of these firms, the nature of their business activities, the allocation of responsibilities and the availability of resources can substantially differ from other mainstream universal providers.

We see the EBA's ongoing work on both qualitative and quantitative indications of default as critical. The EBA data collection exercise on the guidelines on the application of the definition of default is based on several quantitative assumptions. There has been very little public communication on quantitative indications of default since the Authority's October 2014 consultation on credit obligation past due. We would welcome a general clarification on this topic from the EBA.

<u>Past due criterion in identification of default</u>

We welcome the clarification that repayment delays resulting from contractual arrangements or legal restrictions shall not be considered as past due for the purpose of the application of Article 178.1 (b) of the EU Capital Requirements Regulation (CRR).

The draft guidelines specify that the sum of all amounts past due related to any credit obligation of the obligor should be calculated on a daily basis for the purpose of comparison with the materiality threshold set by the competent authority (Article 178.2 (d)). Depending on the jurisdiction and the business segment, practice may vary in this field. We would recommend this aspect to be further discussed to make sure that no disproportionate requirements are imposed on operators.

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 definition of technical default.

The draft guidelines provide that a technical default occurs "where an institution identifies that the defaulted status was a result of data or system error, including manual errors of standardised processes but excluding wrong credit decisions".

It is important to keep in mind that an error can be made by the provider <u>as well as</u> by the customer for example by failing to use correct payment details. It would also be helpful to further clarify the term "wrong credit decision".

The draft guidelines also provide that a technical default can also occur "where due to the nature of the transaction there is a time lag between the receipt of the payment by an institution and the allocation of that payment to the relevant account, so that the payment was made before the 90 days and the crediting in the client's account took place after the 90 days past due".

Though we appreciate the need to provide a technical and precise framework for the identification of default, it is also important to explicitly recognise that a judgmental process is sometimes required. For example, this would be the case where the repayment delay does not depend on financial circumstance (e.g. asset accident/loss not contractually foreseen) or in the event of disputes related to the provision of additional services to the financial contract (e.g. maintenance services associated to the leasing of equipment can often take more than 90 days before being resolved).

It is also worth stressing that for larger/key accounts such as public sector entities or very large corporations, internal payment processes can often lead to repayment delays which are not due to financial circumstances. As these clients are typically highly unlikely to fail and default on their agreements, it would be useful to clarify whether an "intention to pay" would be sufficient to effectively re-age the number of days past due for these obligors.

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.*

Not applicable.

Indications of unlikeliness to pay

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

We agree with the proposed approach for the treatment of specific credit risk adjustments (SCRAs). We believe it is very important to ensure that SCRAs related with incurred but not reported losses (IBNR), as specified in article 1.5 (c) of the Regulatory Technical Standards (RTS) on the specification of the calculation of the specific and general credit risk adjustments, should not be considered an indication of unlikeliness to pay.

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

We agree that the sale of credit obligations at a loss may not always result from credit-risk related reasons but can also be justified by liquidity constraints or business strategy. Against this background, the reasons for the sale of exposures and potential losses should be taken into account.

In the case of economic loss due to the decrease in a credit obligation's quality, we support the EBA's recommendation to assess this economic loss against a specific threshold and to provide institutions with sufficient flexibility to set such threshold at a level that is compatible with internal risk management practices.

However, we think that the proposed materiality threshold of 5% for the credit-related economic loss related with the sale of credit obligations is too low and does not sufficiently take into account that pricing is often reduced due to uncertainty in recovery. We think a 10% threshold would be more appropriate.

We also wish to draw the Authority's attention to the specific situation where a credit obligation will be reported by an institution as defaulted before being sold. Not all institutions may be in a position to analyse (post-sale) the quality of a credit obligation without taking into account other on-balance exposures towards the same obligor.

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?*

Distressed restructuring

We support the introduction of a threshold for the diminished financial obligation that is considered to be caused by material forgiveness of postponement of principal, interest or fees. However, we strongly believe that the proposal to introduce a 1% threshold is excessively low. We are concerned that such threshold will lead in practice to the treatment of all commercial renegotiations as defaulted exposures. We think that a higher threshold between 3 to 5 % should be introduced.

Against this backdrop, the costs associated to the introduction of a restructuring clause to the agreement should also be taken into account in the establishment of the threshold.

Other indications of unlikeliness to pay

The Federations take note of the various obligations introduced for institutions in their usage of external data. Local regulatory frameworks may be more detailed than the EBA's Implementing Technical Standards on supervisory reporting on forbearance and non-performing exposures. To promote consistency across jurisdictions, we believe it is necessary to clarify that the obligation to ensure appropriate equivalence of asset quality definition only applies to those exposures identified at European level i.e. performing exposures, forbearance and non-performing exposures.

As regards the treatment of credit fraud, we would welcome a clarification that such fraud can be identified on the basis of the initiation of a legal procedure.

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?*

No specific comment.

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?*

As a general observation, we believe it is very important to rationalise the conditions for reclassification to a non-defaulted status. Against this background, we think the introduction of a general "three month" probation period before the return from default to non-defaulted status is sensible. It is worth highlighting here that the outcome of the assessment of an obligor's likeliness to pay its obligations in full will differ from an institution to another.

A wide variety of methodologies for cured assets have been adopted across the industry during model development. The implementation of probation periods should be careful phased-in to mitigate business impact (we expect important IT costs) and allow for the appropriate time for adjustment of models.

For those institutions using the advanced IRB approach, the definition of "cured" exposures matches the definition of exposures "returned to non-defaulted status". This definition is used in Loss Given Default (LGD) models assuming that the residual credit at "curing" time will be repaid in full. Such approach requires a very prudent method to avoid the under-evaluation of the LGD. We would like to suggest assessing the possibility to decouple these two definitions to avoid an enlargement of the perimeter of non-performing loans and ensure appropriate/accurate assessment of credit performance.

We are concerned by the introduction of a "one year" probation period for distressed restructuring which, we think, will contrast with operational reality. It is worth recalling that the objective of such restructured agreements is precisely to bring back the borrower to a solvency position. If there is no default following the restructuring, the proposal would lead to a situation where there is no operational default but a default on a prudential basis (i.e. a reporting of prudential default with value zero). We think this would contradict the bankruptcy regimes in several countries where, per the requirement of local authorities, restructured outstandings must be treated as non-defaulted.

In general, the downside of the proposal to introduce fixed probation periods is the potential creation of a gap between the prudential standard and operational features. We would like to suggest assessing the introduction of a requirement based a recurrence rate per exposure category and to adapt the standards accordingly.

<u>Application of the definition of default for retail exposures</u>

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

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 fully agree with proposed approach which allows institutions to choose the level of application of the definition of default (i.e. obligor/facility) for retail exposures according to their respective internal risk management practices. As mentioned in the past, it is crucial to allow sufficient flexibility, in particular for banking subsidiaries, which may not have an extensive overview of an obligor's commitments within a group. For these smaller specialised firms, an application of the definition of default at the facility level is required.

However, we do not believe that where an obligor defaults, this necessarily indicates his unlikeliness to pay his remaining credit obligations. It is important to recognise that in the retail sector, when an obligor experiences difficulties in repaying its debts, the latter will usually identify and first repay priority debts. As a consequence, it is difficult if not impossible, to predict a contagion to the entire portfolio.

We think that where the definition of default applies at the level of a credit facility, institutions should not be requested to assume unlikeliness to pay for remaining credit obligations of a particular obligor. Introducing such requirement would in our view call into question the ability of institutions to benefit from a more granular treatment of default for retail exposures as provided by the CRR. In any case, the proposed threshold of 20 % of exposures is too low.

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

No specific comment.

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

No specific comment.

I remain at your disposal, should you be interested in discussing any specific issue. Alternatively feel free to contact my colleagues Alexandre Giraud (a.giraud@eurofinas.org - tel: + 32 2 778 05 64) and Rafael Alarcon Abeti (r.alarconabeti@leaseurope.org – tel: +32 2 778 05 69).

Yours sincerely,

Leon Dhaene
Director General