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| Nationwide Building Society is pleased to respond to the European Banking Authority’s consultation paper “Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013”.  Nationwide is one of the UK’s three largest mortgage lenders and savings providers, with c. £190bn in assets. As the largest building society in the UK, we are owned by and run for the benefit of our 15 million members. As such, we are unique in UK retail financial services, providing a mass‐market credible alternative to the plc banks, focusing on long‐term, transparent customer relationships. Whilst our core business is residential mortgage lending funded by retail deposits, we are a full service personal finance provider, offering current accounts, personal loans, credit cards, investments and insurance and we are major lenders to the buy‐to‐let market and housing associations.  We support the efforts of the EBA to create a level playing field and harmonised treatment for identifying defaulted exposures. Whilst we agree with many of the proposals, we believe there are some areas which should be left to the risk management processes of individual firms as they are best placed to understand their particular exposures and exercise their judgement accordingly.  We believe a number of changes would be required to the CP before NBS would be a position to fully endorse the proposed guidelines. In addition, there are some areas where we believe it would be useful if the EBA was to provide additional clarification.  In summary, we would highlight concerns in the following areas of the CP, most of which have already been cited by the British Bankers Association (“BBA”):-   * Time required to implement the guidelines. * The counting of days past due. * Technical Defaults. * Indications of Unlikeliness to Pay. * Specific Credit Risk Adjustments (SCRA). * Alignment with IFRS9. * Forbearance and Distressed Restructuring. * New indicators of Unlikeliness to Pay. * Criteria for a non-defaulted status.   We are happy to provide more detail to the EBA on the areas mentioned above and would welcome further discussion if required. |

Nationwide’s responses to the EBA’s questions from the consultation paper are as follows:

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.*

Nationwide does not fully support the guidelines on Technical Defaults. Limiting the definition of technical defaults to IT/systems or data issues appears to be too restrictive and other situations should be considered. Disputes and complaints, credit and non-credit ones are an area where technical arrears may arise and should be considered for inclusion. In regards to commercial exposures we agree with the proposed approach and already have a detailed definition and list of what would typically consist of technical arrears which cover the situations specified.

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

No comment.

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

We are supportive of the clarification made by EBA that the “incurred but not reported losses” (IBNR), should not be considered as an indication of unlikeliness to pay (s26 of the paper)

For retail and commercial exposures, specific provisions are already within Nationwide’s definition of default. For secured retail products the specific provisions and individual assessments are only performed after possession, at which point the exposures are already at default. Immaterial part of the retail portfolio is reported at fair value.

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

We agree with one reservation. It is not unusual for ABS transactions to record large price movements in excess of this level during times of market stress in relation to liquidity, credit deterioration and/or extension risk. The guidance states the loss trigger should only apply where it is related to material credit deterioration but this will be difficult to quantify resulting in the potential for inaccurate and unfavourable financial reporting.

A materiality threshold of 5% will drive more frequent scrutiny and justifications on asset default status, particularly in the case of ABS asset classes, which experience relatively high levels of market price volatility as a result of a number of risk drivers in addition to credit risk. Therefore in relation to ABS asset classes we support the British Bankers’ Association position that having such a threshold is not appropriate.

1. *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?*

Expected cash flows before and after distressed restructuring should preferably use effective interest rate at the moment of signing the restructuring agreement. The effective interest rate will better reflect the current risk of the transaction and therefore risk in the discounted cash flow analysis. However, Nationwide appreciates that in order to align with current accounting standards, the original effective rate is the better option.

Selecting a rate for the discounting of an obligation’s cash flows is made clear through the consultations guidance. The original effective interest rate associated with either the old or new loan agreements contractual terms and conditions should be used with the relevant set of cash flows i.e. old or new respectively. It would be helpful if the EBA were to outline a worked example of the calculation for clarity.

1. *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?*

We do not agree. It appears unreasonable that the discount should be an indicator of unlikeliness to pay. An asset purchased at a material discount should be checked for any other indicators of unlikeliness to pay. Such assessment is normally a part of the due diligence assessment of the asset to be bought, to allow a firm to establish a relevant value/price of the asset. For every asset or portfolio of assets that an institution purchases (with or without material discount) a proper due diligence assessment is performed, including testing the 90 days and the unlikeliness to pay criteria. The assessment could trigger a default.

Paragraph 47 (g) suggests that a loan purchased or originated at a discount reflects a deterioration in the credit quality of the borrower and that this is an unlikeness to pay (UtP) indicator. Furthermore, this event should therefore be considered a default. Can the EBA clarify or provide some guidance as to under what circumstances or conditions such a borrower would be considered to have cured and then returned to performing status.

1. *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 do not agree with the prescriptive nature of this requirement. We believe that the individual firms are better placed to recognise when a customer is no longer in default and we consider the enforcement of set probationary periods inappropriate. Furthermore, lenders should have the ability to set probation periods according to their risk management processes and other appropriate measures such as asset class for example.

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

We agree with the proposal that the lender is able to apply the default definition at either obligor or facility level or both.

1. *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 do not agree that where the obligor is defaulted on a significant part of its exposures this necessarily indicates unlikeliness to pay on the remaining credit obligations of this obligor.

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

We do not agree with the approach proposed. The application of a materiality threshold would do nothing to enhance the practicality of administering the setting of default markers across business streams. We also believe that it would be challenging to apply contagion effects across both retail and commercial loan assets.

We do not necessarily believe that if a joint obligation towards a firm defaults then all the individuals in the agreement are automatically considered as default and therefore recommend that further thinking is carried out in this area.

*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.

We note that the contents of the CP are aligned to CRD IV requirements. There is also an expectation that alignment with the final Basel Committee guidelines will be achieved when these have been released.

We believe it would be useful if the EBA could provide further clarification for the following queries:

Paragraph 47 (d) suggests that breach of covenants of a credit agreement should be treated as a default. Can the EBA clarify whether a distinction can be made in the final draft RTS between financial covenants and non-financial covenants for the purposes of applying this indicator. For the purposes of credit risk, it is the financial covenants that are genuine indicators of a deterioration in the credit risk profile of the borrower and it is suggested the indicator should be limited to only financial covenants.

Paragraph 50 proposes that a credit fraud is treated as an UtP indicator and therefore if identified should be treated as a default. Fraud by its nature is a non-credit risk (specifically an operational risk); it is influenced by factors such as a firm’s systems, controls and the external environment. Including frauds in the default history data would turn modelling of PDs into a matter of modelling probability of fraud on the lender. Given the subjective nature involved in the identification, investigation, reporting and confirmation of fraud events, we suggest that frauds should be excluded from the list of UtP indicators.