afme/ Finance for Europe

Consultation response

Draft RTS on materiality threshold of credit obligations past due under CRR Article 178

30 January 2015

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the EBA's consultation paper on the **Draft RTS on materiality threshold of credit obligations past due under CRR Article 178.**

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 resolving the problem of RWA variability.

A significant amount of RWA variability is due to differences in supervisory approaches and, whilst there may be reasons for national specificities in certain areas, we do not think there is sufficient justification to extend this to the definition of default for capital adequacy purposes.

We therefore think that, in order to reduce unwarranted RWA variability, there should ideally be no discretion for national competent authorities (NCAs) to set their own default materiality threshold, and the same threshold should be applied across the EU by all competent authorities. Otherwise, a variety of supervisory approaches will continue to remain in place and objectives of increased comparability and a single rule book will not be achieved. We appreciate however that, in the case of this draft RTS, the EBA's mandate is to specify the conditions under which NCAs will set the threshold, rather than to set the threshold itself and that the EBA has to work within the confines of this approach.

We are also of the view that when institutions apply an approach to the materiality default threshold that would be more "conservative"[1] than the approach that will ultimately be adopted in the RTS, they should ideally be allowed to continue to do so. We understand this is not what is explicitly envisaged by the CRR (as firms have to comply with whatever materiality threshold is set by NCAs); however, it would avoid the need for firms with the more conservative approach to make unnecessary changes to their models. Given the considerable costs involved in the changes that will inevitably be required through this RTS, we ask that the EBA works closely with the NCAs to encourage them to adopt an approach that keeps the changes required at a minimum whenever possible.

[1] We use the word "conservative" in the sense of recognising more defaults as we understand that this is the approach the EBA would like to privilege (over possible LGD impacts of many cured defaults).

Lastly, while we welcome the EBA's intention to consider the relationships between this RTS and their forthcoming Guidelines on defaults, we also wish to recall that forthcoming BCBS publications aimed at reducing RWA variance will include further consultations on the definition of default. While we understand that the EBA has been given a mandate in the CRR to address the issue of the materiality threshold and will not wish to wait for the international process to be completed, if this RTS is adopted prior to BCBS proposals, it is crucial that the European approach be recognised as being compatible with international decisions given its potentially far reaching implications for firms' internal models and data series. Requiring firms to implement further changes in such close succession would not be efficient and must be avoided.

Responses to the consultation questions

Q1. Do you agree with the approach proposed in the draft RTS (option 1) that default should be recognized as soon as one of the components of the threshold (absolute or relative limit) is breached? Or would you rather support the alternative option, i.e. recognition of default after both thresholds are breached (option 2)?

AFME considers that, given the potentially wide-reaching consequences of the proposed RTS, it is important to design the new approach to the materiality threshold so as to minimise its cost of implementation while maintaining an approach that effectively caters to the variety of exposure types and sizes present across Europe.

In our view, the most appropriate option for achieving these goals would be option 2, i.e. the combination of an absolute and relative threshold where defaults are recognised after both thresholds are breached, with the additional qualification that NCAs should not require change when the firms in their jurisdiction apply an approach to materiality that yields a more conservative outcome (and thus the recognition of a greater number of defaults).

Our reasons are as follows:

- Option 1 is not sufficiently predictive of the true realisation of credit risk and would lead to the recognition of too many technical defaults. A large number of technical defaults could worsen the quality of data used for internal estimates and create data instability (many non performing exposures (NPEs) returning to non- defaulted status within a relatively short time frame).
- In many cases, the absolute threshold would be the binding threshold under option 1. As the absolute threshold is not proportionate to the size of the exposure, we do not consider this to be appropriate, particularly for non-retail lending where exposure sizes can vary greatly. Consider for instance two facilities: one facility is an advance of €1,000 to an SME and the customer is 90 days past due by €501; the second facility is an advance of €1,000,000,000 and the customer is 90 days overdue by €501. The first case is clearly materially overdue and the second is not.
- Given the heterogeneity of credit risk exposure levels across European countries and within banks, it is very difficult to define a single absolute threshold that would work across a broad range of exposure types and separately from a relative threshold.
- Given current practice, option 2 (with the caveat that firms using more conservative approaches to materiality are able to continue to do so) is likely to have a smaller aggregate impact at European level than option 1

With regards to the reference amount to which the thresholds should be compared, we think that all the overdue amounts relating to an obligor should be looked at in aggregate. However, we think that this should be done across all of the obligor's facilities so as to allow for compensation across a customer's lines. In other words, outstandings should be calculated at counterparty rather than transaction level so that it is the total of any amounts past due together with any available undrawn lines of a client that forms the amount to be compared against the threshold. This total past due amount across facilities is more relevant in assessing the true credit risk of a client than simply considering past due amounts in isolation. It also avoids the risk of artificially closing down transactions and creating new ones simply for the purpose of circumventing default classification.

The reference amount should be assessed at counterparty level for both the absolute and relative thresholds under option 2. However, in case of retail exposures where the institution chooses to apply the default definition on individual credit facility level in line with Article 178 (1) CRR, these absolute and relative thresholds must be assessed on individual credit facility level.

We think that clarification of the language used in Article 2(a) and (b) is required to reflect this, our current interpretation of the proposed text being that the absolute threshold should be assessed against the individual credit obligation past due whereas the relative threshold should be assessed against the total amount of all obligations of the borrower.

Moreover, while we are supportive of introducing as much consistency as possible into the materiality threshold, the EBA should make clear that expert judgement still has an important place within the new framework and can continue to be used. 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.

More clarification would be welcome generally as to what the EBA considers to be a technical default.

Lastly, AFME would also welcome clarification that the "days past due" counter only starts to tick once the materiality threshold has been breached.

Q2. Do you agree with the proposed maximum levels of the thresholds?

We would support the proposed levels of the thresholds (absolute: EUR200 (retail)/EUR500(non-retail); relative: 2%) under option 2 with the qualification that firms currently making use of a more conservative approach should ideally be allowed to continue to do so.

As explained above, we are not in favour of option 1 as it lacks proportionality, particularly in the non-retail space. We therefore would like to stress that, should option 1 ultimately be retained, an absolute threshold of EUR500 is far too low would need to be increased to cater for large corporate exposures.

Q3. How much time is necessary to implement the threshold set by the competent authority according to this proposed draft RTS? What is the scope of work required to achieve compliance?
Q4. Do you agree with the assessment of costs and benefits of these proposed draft RTS?

We address the issues raised in questions 3 and 4 simultaneously given the links between the costs of work required to implement the change and the time period required to do so.

Given firms' numerous existing commitments for which resources have already been planned or allocated and the additional, heavy workload that the proposed changes will create, the implementation period will need to be long and must exceed the two years suggested by the EBA. As described below, the implementation process will, at a minimum, take between three to four years and will very much depend on the extent of retrospective adjustment required by NCAs.

Moreover, the process involved in achieving compliance will be complex and requires changes to IT systems and processes on the one hand and changes in credit risk parameter setters and rating models on the other. Firms will not be able to carry out these processes simultaneously and will have to manage them sequentially, thus further underscoring the need for a sufficiently lengthy implementation period.

The implementation process will involve at least the following:

- Amounts overdue and reference amounts will need to be readily available in the data bases/systems used for RWA calculations as well as credit risk parameter and model recalibrations. If they are not, interfaces to booking systems or workarounds in the respective data bases/systems will need to be introduced.
- Firms will have to consider how to deal with the adjustment of historical default and non-default data. In some cases retrospective adjustments of historical data may not be possible at all.
- Firms will have to recalibrate and validate credit risk parameters and rating models on the basis of the new materiality definition. The number of parameters involved should not be underestimated.
- Firms will then have to assess the implications of the re-calibrated credit risk parameter and models.
- Internal and external governance processes, including the supervisory approval process and use test requirements will have to be carried out.
- Credit officers and users of the recalibrated models will need to be trained.
- The recalibrated parameter and models will need to be implemented, including piloting and test runs.
- Disclosure requirements will have to be updated.

As an indication, our members have provided the following estimates of how long each of these different steps may take:

- Between 6 to 9 months for collecting data and data cleaning, possibly longer for some firms
- Approximately 15 months for model build and development
- Another 6 to 9 months on top of the model build and development state for internal review/governance

- Approximately 6 to 9 months for supervisory review and approval, although this may be significantly longer as it does not take into account the potential backlog that some NCAs may face if flooded with numerous, simultaneous requests.

In total, this would amount to at least approximately 33 – 42 months, if the change is carried out to one model in isolation, i.e. without taking into account changes to all models that may be required as the result of this and other required model adaptations in the pipeline.

The required total implementation time also obviously depends on the number of models in use (several hundred models can be used in a multi-product, multi-jurisdictional bank), how far back firms have to apply the new thresholds and the depth and length of supervisory approval processes.

We think it is in these areas in particular that the EBA and NCAs can help alleviate the burden for firms:

- For instance, one way of dealing with this level of complexity and the CRR requirement for 7 years historical data would be to allow firms phase in the changes so that full implementation is achieved after 7 years, rather than requiring firms to apply the new definition retrospectively.
- If retrospective adjustment is required, the extent of the adjustment should be carefully discussed and agreed with the NCA in order to minimise the workload for firms.
- The EBA should advise NCAs to agree a phase-in period with their respective supervised firms. This phase-in period should deal with the most material models first with futher implementation being staggered from there on out.
- A very important contributor to costs and the required time for implementation will be obtaining the necessary approval from NCAs. In order to mitigate this burden, we recommend that relief be provided so that firms should not be required to ask for individual supervisory approval prior to making changes to their models if these changes are not material. In other words, the EBA should clarify in its RTS (Recital 7) that changes to the materiality threshold may not necessarily result in material changes to internal rating models. When a firm is able to prove that such changes are not material, they should be allowed to notify the competent authorities through a single ex-ante or ex-post communication covering all such changes (and not on a model by model basis). Putting a simplified process in place will also help NCAs themselves cope with the burden of having to review potentially hundreds of models at the same time.

The ultimate implementation period will therefore have to be agreed between firms and their supervisors on a bilateral basis. This will also have to take into account forthcoming proposals (e.g. from the BCBS or the EBA) in the field of the definition of default and in other areas of changes to models. All of these changes should be carefully coordinated to avoid multiple change processes such as those described above having to be carried out in short succession.

Q5. What is the expected impact of these proposed draft RTS?

Given the connections between the recognition of an increased number of defaults on PD levels and the impact of many defaults curing and thus affecting LGD levels, it is extremely difficult to provide a robust overview of the overall impact of the proposed draft RTS within the consultation deadline. We therefore encourage the EBA to carry out a thorough quantitative impact assessment before finalising its proposals.

Moreover, we think that there is a more general need for the EBA to consider the comprehensive impacts of forthcoming changes to models that will be required in the context of increased harmonisation. Indeed, the EBA's programme of IRB repair is likely to lead to changes of all models and, while we understand its objective, the programme in its entirety needs to be subject to a cost/benefit test.

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