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Mr. Andrea Enria
European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA
United Kingdom

Re: Consultative Paper – Guidelines on the Application of the Definition of Default

Dear Mr Enria:

The Institute of International Finance (IIF) welcomes the European Banking Authority (EBA) Consultation Paper *Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013.* The IIF strongly supports the EBA's focus on this important area, and we appreciate the opportunity to comment on these Guidelines.

The IIF continues to promote the harmonization of credit risk modeling practices, parameters and assumptions, as a means of helping to restore the credibility of internal models within the capital framework. We maintain the view that the risk-sensitivity delivered by internal models is of critical importance in banking, not least in ensuring appropriate signaling and encouraging desired behaviors, whilst simultaneously acknowledging the need to improve comparability and transparency of banks' models.

This was highlighted in the IIF RWA Task Force's Final Report in November 2014, which contained 78 recommendations for harmonization within credit risk modeling, 16 of which related specifically to the Definition of Default. Within the scope of these recommendations, we had also identified some areas that would benefit from clearer regulatory guidance and/or greater supervisory consistency, and we commend the EBA for pursuing this agenda.

In this context, we see the EBA's Consultation Paper as being highly constructive, in providing greater regulatory clarity as well as championing the process of harmonization.

The IIF also encourages the EBA to liaise with its international regulatory peers, and to escalate these proposed Guidelines for consideration at the level of the Basel Committee on Banking Supervision (BCBS). Indeed, where these Guidelines can help set the basis for appropriate harmonization to narrow the range of RWA variance, this agenda should be pursued globally. We commend the EBA for its leadership and initiative in this Consultation Paper, and we urge the EBA to promote discussion via BCBS fora, to help support greater international consistency and comparability.

Concurrently, we note that the IIF RWA Task Force's analysis identified that some sources of RWA variance reflected legitimate differences between banks' portfolios, data histories and risk management policies and practices. As such, in the pursuit of appropriate harmonization, it is important to distinguish between modeling differences that are accurate representations of underlying differences between heterogeneous banks, and those items causing RWA variances due to interpretations and definitions that are unrelated to underlying risks.

As such, the IIF is pleased to convey our broad support of the EBA's proposals, whilst also identifying some specific technical items that we feel warrant some further consideration.

Our detailed responses to each of the 11 specific questions posed in the Consultation Paper are set out in the following pages, but we wish to briefly highlight three themes that feature in our feedback, as follows:

- Alignment with IFRS 9: we note some areas of interpretational differences and potential conflicts with IFRS 9's three stage assessment for a Significant Increase in Credit Risk (SICR); as recommended in the IIF RWA Final Report, we encourage greater alignment of prudential and accounting standards where possible, or at least acknowledgement of the specific items where there are such differences.
- The role of expert judgement: we acknowledge the desirability of tightening the scope for exercising discretion, particularly as a means of supporting consistency, but believe there are some areas where a role for judgment may still be required; to this end, we support the retention of a limited role for expert judgement, constrained by internal policies that are agreed upon with supervisors and supported by appropriate disclosures.
- Recognition of non-credit drivers: we commend the EBA for identifying that some discount sales reflect non-credit factors such as changes in business strategy, and we note that this equally applies to the use of indicators such as bond prices: whilst a reduction in a bond price may serve as an early indicator of deteriorating credit quality and a potential future default in some instances, such price movements might also reflect unrelated factors, like a shift in interest rate conditions; as such, these indicators should be used with caution.

We also note that if these Guidelines are to be applied retrospectively, there would be substantial challenges in re-stating historical data. We propose having a detailed dialogue specifically on implementation and operational matters, to ensure that the changes can advance the harmonization objective and not lead to any unintended anomalies.

The IIF hopes that our comments are helpful as the EBA finalizes these Guidelines. We emphasize our support, and we welcome ongoing dialogue on this important matter. As in the past, the IIF stands ready to provide further input and any necessary expansions or clarifications on all of our comments.

Sincerely,

Andrés Portilla

Responses to the 11 specific Questions posed in the Consultation Paper:

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.

The IIF is supportive of the notion that exposures that are technical defaults should be excluded from the definition of defaulted exposures. The exclusion would result in defaulted exposures accurately representing genuine defaults and the level of defaults would not be artificially inflated.

Whilst we agree with the overall concept, the IIF would also like to provide the following proposals to allow the definition of technical defaults to be more comprehensive:

1. Scope for expert judgement: we note that Paragraph 20 details that the classification of an obligor as a defaulted exposure should not be subject to expert judgement. Whilst we acknowledge (and support) efforts to drive greater consistency between banks' treatments, we are concerned that the complete removal of expert judgement could result in the classification of some obligors as defaulted exposures even when other factors indicate that the obligor has capacity to continue paying the obligation. We support a constrained retention of expert judgement, in which expert judgement could be applied under internal policies that are agreed upon with supervisors, and subject to appropriate disclosure. This would provide a more accurate classification of exposures in default.

2. Other technical default cases: the draft provides two clear examples in which an obligor is considered to have had a technical default, but there are additional scenarios in which an obligor does not make a payment for non-credit reasons. For instance, there can be leasing contracts where the obligor suspends payment because the service is no longer provided, or there is an equipment failure (this has commonly occurred with departments of some major European national governments). In order to address this, the IIF proposes that a further case be added, as sub-section (c) to paragraph 20, for obligors who miss a payment for non-credit reasons

Question 2: Do you consider the requirements of factoring arrangements as appropriate and sufficiently clear? If not, please provide proposals for additional clarifications

We agree that the factoring requirements detailed in the draft guidelines are sufficiently clear, and we believe that the two distinct, common types of factoring are well described in paragraphs 22 and 23.

Concurrently, we feel that the Guidelines could be strengthened by considering the scenario of contagion from factoring arrangements to an obligor's other facilities.

There are examples of an obligor paying late on factoring arrangements for reasons not related to a credit or liquidity issue, such as where the service is no longer being provided, or where leased devices are no longer working. There is a risk of an obligor's other obligations being mis-classified as defaulted on the basis of such contagion from a factoring arrangement, which we feel would be unintended. This is particularly pertinent for cases where an obligor has ceased to make factoring payments for such a reason, but is still meeting its other (eg. loan) payments.

Consequently, we suggest that the Guidelines should provide for the consideration of the underlying cause and nature of late payments, and to make a determination on a case by case basis if factoring arrangements have sufficient material impact that would cause the obligor to default on its other obligations.

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

The IIF considers that the paragraphs relating to the definition of specific credit risk adjustments are clear, but we note some key issues in the interaction of the Guidelines' Specific Credit Risk Adjustments (SCRA) and IFRS 9, which warrant careful consideration.

The IIF notes a number of mismatches between IFRS 9 Stage 3 (ie. 'credit-impaired' status) and the definition of default as per the Consultation Paper. A mismatch between the two definitions could further exacerbate the disconnect between risk and accounting measures.[1]

A summary of some of the alignments and differences are as follows:

- Default triggers under the regulatory definition will generally also trigger Stage 3 arrangement.[2]
- The IFRS 9 criteria for putting an exposure into Stage 3 is slightly broader than the default scenarios on a regulatory basis, so some assets could potentially be assessed as being impaired without yet being classified as defaulted. For instance, there are jurisdiction-specific scenarios under which an asset could be considered credit-impaired under IFRS 9 without being in default for regulatory purposes, in cases where the accounting presumption is not rebutted.[3] Accordingly, it is important that banks have the ability to not classify all exposures in Stage 3 as defaulted, on an exceptions-only basis.
- Assets that have been in default and then subsequently cured may move from Stage 3 to Stage 2, whilst still being subject to regulatory requirements for staying in default status for a longer period post-cure (please refer to our comments in reference to Question 7 and probation periods also).
- Assets that are already credit impaired at origination or purchase (eg. where they have been purchased at a deep, credit-related discount) will be considered as in default for regulatory purposes, whereas IFRS 9 requires that they are subject to a lifetime expected loss treatment with no Stage status prescribed.

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

The IIF is broadly supportive of the proposal, and agrees on the need to recognize an unlikeliness to pay to the extent that a material credit-related economic loss is realized on the sale of an obligation.

For clarity, our interpretation of this section is that it is intended to address the specific scenario where an obligation has not yet met any other default trigger (including unlikeliness to pay), when a sale at a material discount then occurs. As such, this section does not over-ride (or re-assess the timing of the default-point) for the other scenarios where the obligation has previously met default criteria.

On that basis, the suggested materiality threshold is appropriate, and realizing a default at the time of sale is appropriate in such a scenario.

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[1] Under IFRS 9, there is a distinct 3-stage allocation for Expected Credit Losses (ECL), based on the increase in credit risk since initial recognition: Stage 1 reflects assets with no Significant Increase in Credit Risk (SICR), Stage 2 includes assets that have experienced SICR but are not credit-impaired, and Stage 3 assets are credit-impaired.

[2] IFRS 9 B5.5.37 requires a consistent definition between accounting and risk management. The BCBS Guidance on credit risk and accounting for ECL further recommends that the definition of default adopted for accounting purposes is guided by the definition used for regulatory purposes (d350-A4).

[3] IFRS 9 B5.5.37 includes a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is appropriate.

We also note that not all sale discounts are for credit reasons, and we commend the EBA for making the distinction in paragraph 31 between credited-related discounts and those for scenarios where a bank might sell assets because it needs liquidity or because it has undergone a change in business strategy. We agree that the assumption of a default having occurred should only apply for cases where the discount reflects a credit rationale, and that discounted sales should be subject to this test.

Similarly, we highlight the issue of bond prices. The IIF acknowledges that a discounted bond price can be an indicator (albeit a very early one) of credit deterioration and the potential for a default. However, credit deterioration is only one of the factors which can influence bond prices. For instance, changes in market and official interest rates can affect the relative value of the coupon for investors. Bond prices can also reflect changes in investor sentiment (risk aversion) and shifts in market liquidity, which has been an increased concern in recent times.

Accordingly, the IIF is of the view that a shift in bond prices (and therefore the sale of a bond at a discount) greater than the materiality threshold should not be an absolute indicator of default. We suggest that bond price reductions should be subject to an additional determination as to whether that price movement is deemed to be credit-related.

We also suggest that there should be a symmetrical treatment in the definitions for the sale and purchase of discounted assets; please see our comments in reference to Question 6.

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 arrangements? Do you consider the specification of the interest rate used for discounting of cash flows sufficiently clear?

Firstly, as a matter of interpretation, the IIF seeks confirmation that the distressed restructuring requirements are restricted only to credit restructuring scenarios, and are not to apply for scenarios of commercial renegotiations. We note that, for instance, there can be a change in interest rate as part of a commercial renegotiation to correspond to a change in seniority or ranking, or security. We note that depending on the volatility in local market interest rate conditions, the magnitude of a change in such a commercial renegotiation could be substantial.

On the basis that this is applicable only for credit-related restructures, we are supportive of the proposal to harmonize the basis of the discount rate applied, which we agree would help to reduce an area of RWA variance. We also support harmonizing the proposed threshold as set out in paragraph 40, but we believe it would be more appropriate to set this at 5% than at the proposed 1%. This would further improve consistency, as it would bring this threshold into line with the one proposed for the sale of assets in paragraph 33 (Question 4).

We do not have an especially strong view as to which basis of discount rate that should necessarily be, although we agree that the proposed use of the most recent rate prior to restructuring is likely to be the most practical.

In general, we agree that the proposal is clear. One point to consider is in the scenario of floating-rate contracts, for instance where a loan may be priced at a margin over LIBOR or EURIBOR. We would welcome clarification as to whether the calculation in such cases in intending to test materiality at an absolute or marginal level.

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?

On balance, the IIF agrees that the proposed treatment is appropriate for scenarios where the material discount reflects an issue with the obligor's creditworthiness, in the case of a single-asset purchase.

Concurrently, we note (and support) the definition set out for the discounted sale of a credit exposure, as described in reference to Question 4, which indicated unlikeliness to pay where that sale price reflected credit reasons, but made the distinction for the sale of assets where a bank needs liquidity or has changed business strategy.

We consider it desirable to have symmetrical definitions for both the sale and purchase of credit obligations. Accordingly, we would propose adding an additional criterion to this definition, to reflect that the reason for the discount is credit-related. We also suggest that this criterion should entail individual assessment of the obligor's creditworthiness and not rely solely on rating agency downgrades, which may be informed by other factors.

We note that whilst the proposed treatment is appropriate for credit-related discounts on the purchase of an individual asset, the same may not hold for the purchase of a portfolio. Where a portfolio is purchased at a (credit-related) discount, the blended discount rate would likely indicate impairment or default conditions on some assets within that portfolio, but not necessarily all. It would therefore not be appropriate to automatically categorize all portfolio assets as being in default.

For clarity, we also reiterate our observation in reference to Question 3 that treating such assets as defaulted for regulatory purposes does not necessarily deem them to be in Stage 3 for IFRS 9 purposes, if they are treated as purchased or originated credit-impaired financial asset under IFRS 9.

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?

There are currently a number of different requirements for probation periods applied, and the IIF believes this is an area that could be converged.

For instance, these proposed Guidelines suggest that any defaulted exposure will remain in default for a minimum period of at least 3 months from the date when default trigger no longer applies, whilst the EBA's Implementing Technical Standard (ITS) on forbearance and non-performing exposure mentions a probation period of one year for restructured loans. Simultaneously, we note that IFRS 9 requires "consistently good payment behavior over a period of time before the credit risk is considered to be decreased" for restructured loans, though it does not specify a probation period for that migration[4].

With consideration to the fact that these proposed Guidelines and IFRS 9 might use a different test, the IIF recommends that the EBA engage with the BCBS and international accounting standard-setters to pursue the development of Guidelines that are consistent between both risk and accounting measures, to the extent possible.

[4] See IFRS 9 paragraph B5.5.27

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

The IIF agrees with the proposed approach, specifically that the approach used by banks should align to internal risk management and business models, and also that banks should clearly specify their approaches and be consistent over time.

This section of the Guidelines text is consistent with a finding of the IIF RWA Task Force report of November 2014. The IIF had highlighted that the identification of defaulted exposures is not always clear cut in terms of isolating credit facilities – that for instance, where a payment to a mortgage, car loan or credit card is deducted from an overdraft account, and puts that overdraft account into excess, there may be different approaches as to whether a bank should 'look through' the excess drawings to the underlying loan that has put the overdraft into default. This is an example of where modeling variances might reflect banks' respective risk management policies and practices, and we agree that heightened disclosure is preferable to harmonization in this particular instance.

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 obligations of this obligor?

In the IIF RWA Task Force's detailed analysis of banks' modeling practices in our 2014 Final Report, we identified that "the choice between obligor versus facility default is deeply ingrained in internal client and risk management practices." This report noted, for instance, the scenario where a retail obligor may have mortgage and credit card facilities that may each be subject to a "different risk and legal context" and that "mixing the two categories does not make sense from a risk management point of view." The degree of connection between products (and the accuracy of default on one as indicator for another) may therefore vary according to banks' origination practices and business model structure.

Consequently, this was one of the specific areas in which the IIF RWA Task Force did not recommend harmonization, seeing this instead as one of those areas where different patterns in banks' approaches may reflect legitimate underlying differences between heterogeneous banks.

We also commend the EBA for identifying that automatically classifying more accounts as defaulted could lead to excessive cure rates and therefore LGD rates that are unnecessarily low. We had identified the same issue, and we feel this is a further reason to not unduly straitjacket default status for all cases.

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

The IIF is broadly supportive of this proposal, and endorses most of the scenarios described. The clarifications set out in paragraphs 85, 86, 88 & 89 are particularly helpful, and will assist in harmonizing practices.

As outlined in our comments in reference to Question 9, we note the limits on the appropriateness of harmonization when we come to look at facilities that are managed across different divisions for both risk management and customer management purposes. Accordingly, we have some concerns with paragraph 87, which would seem to mandate contagion between the personal accounts of individuals and related business accounts for the likes of SMEs. Such an automated association would run counter to common management approaches across divisions, as well as contravening some national legal structures.

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

The IIF is broadly supportive of this proposal, whilst noting the risk of a conflict with IFRS 9 in respect of sub-section (b) of paragraph 99. Specifically, if the definitions required for prudential and accounting purposes are indeed to diverge, this will present a challenge for banks in which set they apply in their internal reporting.