Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013 (EBA/CP/2015/15)

Key Points

1. The APB welcomes the opportunity to comment on the consultation paper published on September 2015 by the European Banking Authority (EBA) on the application of the definition of default under Article 178 of Regulation (EU) 575/2013.
2. APB generally supports the comprehensive and detailed EBF response to the present EBA consultation paper. However, regarding the treatment of specific credit risk adjustments and the relationship with IFRS 9 framework, it is our opinion that, if the current proposal is maintained, severe circularity and conceptual problems can arise, as explained in more detail below.

Treatment of specific credit risk adjustments

Regarding the non-accrued status, the consultation paper defines that "*an obligor is unlikely to pay where <u>interest related with credit obligations are no longer recognised in the income statement</u> of the institution due to the decrease of a credit quality of the obligation.*"

Although we agree that a non accrued status reflects a default situation, the way IAS are defined regarding the recognition of interest in the income statement is too wide and too subjective. Different practices exist in different banks in the same jurisdiction regarding what is considered an unproductive loan (e.g. 30 days past-due vs 90 days past-due, unless there is certainty that it will not be received).

For the sake of harmonization and taking into consideration the idiosyncrasies of each bank's accounting procedures, paragraph 24 should be deleted.

In what concerns the treatment of specific credit risk adjustments, it is our understanding that EBA should acknowledge that any reason that justify a Stage 3 classification should also justify a default status and vice-versa. That is, regardless of the models used, Stage 3 and default mean exactly the same and so, the default triggers for capital requirements models should be the same as the ones for Stage 3 impairment purposes. As such, definition of default by EBA should not rely on stage 3 as one of the triggers to default because the presence of stage 3 requires a previous identification of defaults.

If such a clear definition is not made by EBA, the use of the impairment results to identify credits in default will originate a two folded problem:

- <u>Circularity problem</u>: Banks must calculate PD/LGD first (in a first instance, by defining what is a default) and then use them to calculate impairment and not in the reverse order, which implies that impairment figures should not be used as an input for default triggers. According to IFRS 9, credits in default must be placed in Stage 3, but EBA is defining that Stage 3 credits must be considered in default. In our opinion, a bank identifies a credit in default (and places it in Stage 3) because of a selected trigger is active and not because that credit is on Stage 3.

- Conceptual problem: EBA proposes that impairment should be considered a sign of unlikeness to pay (and consequently a default). As this subjective rule must be transformed into an objective one, the supervisory authorities have and will define quantitative impairment thresholds to assess this sign. The impairment coverage percentage won't be a good measure to identify a credit in default. For instance, a credit with a very high PD (close to 100%) may be well protected with collateral and the impairment may be close to zero (LGD close to 0%). This does not mean that the credit should not be marked as defaulted. On the other hand, a credit with a PD of 20% and an LGD close to 100% will have a high EL expectation, but this does not mean that the obligor is in default (PD is far from 100%). If this specific obligor must be marked as default, PD will no longer be 20% but 100%, and the impairment value will artificially increase up to 100% (100% x 100%). This also creates a circularity problem.

  In our opinion it is crucial to have the Stage 3 classification driven by the ability to pay regardless of the loss given default (collateralization level). If an exposure is allowed not to be classified as Stage 3 due to the nature of its collateral, then Stage 3 and default sets may not coincide, which in our view is not desirable.

If EBA does not define an objective rule and leave the subjective impairment rule for a more objective interpretation by the competent authorities, specific impairment thresholds will be placed (e.g. impairment rate above 20%) for default purposes which will originate that any loan in default should be placed on bucket 3. This scenario will create a significant problem as a substantial part of bucket 2 loans (not default under IFRS 9) will be marked as default under EBA definition and, consequently, would migrate from stage 2 to stage 3 for IFRS 9 purposes.