ABI Position Paper on EBA document: “Draft Regulatory Technical Standards on Materiality Threshold of Credit Obligation Past Due Under Article 178 of Regulation (EU) 575/2013)”

January 2014

POSITION PAPER

INTRODUCTION AND POINTS OF PARTICULAR INTEREST FOR THE ITALIAN BANKING SECTOR

The introduction of a **very low absolute threshold**, not suitably adapted to the various portfolios, combined with the **dramatic decrease in the relative threshold** from the levels that had applied in Italy for some time, results in a considerable impact on the amount and number of past-due positions, which, additionally, in light of customer behaviour, long subject to study, include a significant proportion of "**false positives**," i.e., past-due positions that are rapidly reclassified to performing (a high cure rate).

In each country the national authorities have, until now, adopted the thresholds that best captured, within the context of reference, the actual problematic credit situations and minimise the cure rate for past-due exposures; accordingly, lowering the threshold in effect in the various countries that make use of it, albeit with the entirely laudable intention of achieving harmonisation at the European level, could have a significant negative impact on the corresponding markets (e.g., an increase in technical past-due positions, as will be discussed in detail below), whereas in countries in which equal or lower thresholds are customary in banking practices and in the behaviour of banking counterparties, there would only be a minimum reduction, if any, in past-due positions. This fundamental assumption is the basis for the need, as proposed below, to adopt a threshold carefully chosen with the aim of minimising, on average, the cost associated with the change in question.

The additional requirement that the **two thresholds are to act independently aggravates the situation considerably**, leading the new regulatory framework to diverge significantly from a realistic representation of risk.

The tightening of overall measures is also to be evaluated in cases of particular categories (such as “Central governments or central banks”, “Regional governments or local authorities” and “Public sector entities).

Furthermore, the proposed rules are **pro-cyclical** by nature and especially with respect to the first application (see also answer to Q4 on the risk of an upward shift of the credit offer curve).

The impact of these new measures on banks and their customers should be evaluated by also taking into account the interaction with the EBA ITS focused on NPE and forbearance (i.e. exit criteria from past due/non performing status and from forbone status).

In summary, as elaborated above, EBA should consider to:

1. **opt for the Option 2** defined in the question Q1; Option 2 is the preferred one because the number of introduced technical default ("false positive") is less than the ones presented by Option 1

2. **raise to 4% the limit of the relative threshold**. Given the maximum level of 5% in EU a 4% threshold already represents a relevant 20% reduction with respect to the actual level. In addition it must be said that the average of the actual levels in EU (range from 2% to 5%) is closer to 4% than 2% ad proposed by EBA. Considering that the document states that "*The objective of the materiality threshold is to identify and exclude the so called 'technical defaults'*" there are evidences that the past due cure rate grows not negligibly while reducing the relative threshold. This witnesses that the EBA proposal does increase (instead of eliminate) the "noise" of technical defaults

3. raise the limit of the absolute threshold both for retail portfolio and for the corporate portfolio

4. allow the possibility to **compensate unused** credit lines with **overdue amount**

5. allow the possibility to start the **counter of the days past** due only after the materiality thresholds are both exceeded

6. introduce a sufficient delayed entry into force of the new provisions (see reasons behind this explained in Q3) and a global coordination with other fine tuning rules in the field of default definition that are currently under discussion.

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)?

The choice to regard as in default positions that exceed just one of the two thresholds (absolute or relative) is highly penalising, especially for **customers with significant exposures who are past due by an insignificant amount in relative terms**. For example, in the case of a customer with a past due account balance of 600 euro, and a total exposure of 1,000,600 euro, the absolute amount threshold would be exceeded, but the relative threshold would not, because the amount past due comes to 0.059%. However, if it were sufficient for just one of the threshold values to be exceeded, the position in question would have to be classified, unfairly, as non-performing.

Option 1 is not predictive enough of the materialization of credit risk and would instead include many cases due to other circumstances (so called **"technical past due"**): classification to non performing exposures triggered by small amount later shown as very far from an actual default (e.g. neglected payments, payment processing errors, etc.). Therefore under Option 1, materiality threshold would create a large number of defaults with return to a non-defaulted status in a short timeframe after the recognition.

In addition, the benchmark analysis produced by the EBA with respect to the European scenario shows that the practice of considering even just one of the two triggers for the purposes of exceeding the threshold is not the most common one: on the contrary, it is among those least frequently adopted, and the harmonisation would entail a change and tighter conditions for most European banks. The following is a discussion (as provided by the EBA) of how thresholds are handled in the major European countries:

- in Germany, both thresholds must be exceeded;
- in Italy, only the relative threshold (5%) must be exceeded;
- in the United Kingdom, only the absolute threshold must be exceeded.

As illustrated in that same EBA document, this particularly conservative approach ("Option 1"), would not allow a clear distinction between technical default and true default.

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

The consultation paper does not elaborate in detail on how the calculation of the past due **amount** to be used as **numerator** of the **relative threshold** or to **be compared against the amount of the absolute threshold** should be done. In particular, the following points should be confirmed:

1. the possibility to **compensate at debtor level the unused credit lines with the overdue amounts** should be allowed, for the following two reasons:

    a. in the credit application and also during annual review, the relevant amount - besides the total sum of possible risk which is normally assessed and observed - is the currently used amount in total. That means that the most important amount is the sum of the outstanding while it is less important the way this outstanding is used. Therefore the sum of granted facilities with the used amount (=outstanding) has to be taken into account. Of course in some internal processes also single transactions are monitored but, for the overall risk assessment of a client, it is more important to observe the debtor’s outstanding rather than to observe each single transaction;

    b. it is theoretically possible to stop the overdue days of a single transaction by closing this transaction and by opening a new one to influence the past due calculation. By summing up all outstanding amounts such danger can be avoided;

2. **the possibility to start the counter of the days past due only after the materiality threshold is exceeded** should be allowed, given the fact that materiality threshold is normally set to filter cases which are not material. For these cases no days past due are to be considered. Only once materiality threshold is exceeded, the number of days past due should be measured;

3. **the possibility to allow that the sum of all the amounts past due more than 90 days should be considered** and not all the overdue amount when only some of the overdue amount exceed 90 days, as correctly stated in the consultation proposal.

Due to their administrative specificities regarding the debt payment process there are particular arrangements in place for the portfolios “Central governments or central banks", "Regional governments or local authorities" and "Public sector entities"[1].

Therefore, **we strongly request** that, alternatively:

- this treatment **continue** to be applied;
- the **maximum days past due be extended to 180 days** for public sector entities, applying the **national discretion** envisioned in Art. 178.1.b) of Regulation 575/2013; or
- there be specific absolute and relative thresholds for these portfolios (of some order of magnitude higher than for other portfolios), and past-due status be conferred only when both have been satisfied.

In reference to the **denominator**, given that it is indicated as the "*total amount of credit obligation"* and not the "*carrying amount*" we request confirmation that the unused amount of credit facilities may be included in the denominator.

Finally, it should be noted that in Italy the relative threshold is currently calculated by comparing past-due loans (numerator) to total on-balance sheet loans to customers. We request that you clarify and confirm that the scope of past-due positions relates to on-balance sheet exposures.

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The levels of the **absolute thresholds** proposed by the EBA (€ 200 for retail and € 500 for non-retail) are highly penalising, and in most cases would result in the threshold being exceeded after the first missed payment.

With respect to the absolute thresholds, we request a disclosure supplement on the benchmark analysis produced by the EBA to justify the use of such low amounts as thresholds. For borrowers with exposures of hundreds of

[1] In cases of exposures that for prudential purposes are classified in the portfolios "Central governments or central banks", "Regional governments or local authorities" and "Public sector entities " - for the purposes of reporting only non-performing past-due exposures - for both IRB banks and those that adopt the standard method (a) the consecutive period of past-due status ends if the debtor makes a payment on at least one of the positions considered past-due for more than 90 days (b), or if legislative measures are taken with the aim of ensuring that it is temporarily impossible to collect on claims against the debtor entity and for such time as the measures in question remain in effect (c).

(a) This category should also be considered as including exposures for which IRB banks have been permitted, permanently or temporarily, to apply the standard method.

(b) Exposures to "Central governments or central banks", "Regional governments or local authorities" and "Public sector entities" are considered "past-due" when the administrative verification and liquidation procedures required by law have been completed.

(c) For example: Art. 11 (2) of Law Decree No. 78 of 31.5.2010, enacted into Law No. 122 of 30.7.2010, containing urgent measures concerning financial stabilisation and economic competitiveness.

thousands of euro (retail, corporate or PSE), setting an absolute threshold of less than € 1000 effectively prevents sound discrimination between technical and true default.

In addition, as indicated by the EBA, in the context of classifications of the threshold in terms of **absolute threshold**, no product-based rationales have been introduced (exposures secured by real property, for example, are recognised as a well circumscribed category both in the standard approach and IRB approach and have peculiarities that should deserve a dedicated threshold; the same may be said for the public sector, which in CRR is treated as a specific type).

For loans classifiable as **consumer credit** and **mortgage loans** to families, as well as **asset finance** (leasing, hire-purchase, credit consumption, and commercial loans) - there is a need for both thresholds to be exceeded for an exposure to be classified as in default, It is believed that a suitable **absolute threshold** in the above mentionated cases, would correspond at least to the **amount of one instalment/monthly payment** (past-due status would be triggered at the third unpaid instalment/payment, and that threshold would thus be directly proportioned to the amount of the contract). This criterion - which would have the effect of rendering the absolute threshold "partially relative" as well - would attenuate the risk of disparity of treatment between cases of different amounts and terms.

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The **relative** threshold of 2% is penalising for Italy (for which the threshold is currently set at 5%) and would result in significant discontinuity from the current situation. In addition, in this case, no distinction has been made between the relative threshold broken down by customer type (retail/corporate) or product type (term, on demand, medium/long-term, secured/unsecured, etc.).

The limits currently used in European countries range from 2% to 5% of the exposure. **Selecting a threshold of 2% implies by definition an increase of the non performing exposures at European level**.

We consider appropriate that it be set to 4% of the total amount of all credit obligations of the borrower. This request derives from the following evidences.

Given the maximum level of 5% in EU a 4% threshold already represents a **relevant 20% reduction** with respect to the actual level.

In addition it must be said that the **average** of the actual levels in EU (range from 2% to 5%) is **closer to 4% than 2%** ad proposed by EBA.
Considering that the document states that "*The objective of the materiality threshold is to identify and exclude the so called 'technical defaults'*" there are evidences that the past due cure rate grows not negligibly while reducing the relative threshold. This witnesses that the **EBA proposal does increase (instead of eliminate) the "noise" of technical defaults**.

It bears reiterating that it is advisable for the absolute materiality thresholds to correspond to, at minimum, the amount of a monthly instalment, at least for loans classified as **consumer credit** or **mortgage loans** to families. It bears noting that the **relative threshold** of 2% corresponds to at least the amount of a monthly instalment only if the residual duration of the repayment schedule is greater than or equal to 50 months. A threshold of 5% would thus be much better suited to representing a retail portfolio, in that it would correspond to the amount of one instalment for **residual durations of 20 months.**

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The various measures proposed, considering scenarios with a strong presence of small and medium enterprises and artisans characterised by flexibility in their dealings with their customers, would entail a momentous change in the **operating culture of banks' customers** that can only take place **over a very long period of time**.

In the meantime, the banking system would be, at the administrative level, overwhelmed by an **extremely large number of positions reclassified as non-performing**.

Even in the short-term, it is believed that the combined provisions of the various measures would entail a large number of false positives, and thus an **incorrect and unstable representation of portfolio quality**.

In addition, the number of loans reclassified as non-performing would result in a **reduction of banks' willingness to provide** credit or measures offering tolerance to borrowers affected by temporary liquidity issues, thereby triggering a further decline in economic performance, with a **direct impact on GDP** (see also Q4).

Finally, we regard it as fundamental, in the spirit of the proposal, **to proceed with advance harmonisation of the definition of "default"** throughout the European Union. More specifically, we believe that if the definition and application of the concept of "default" were not to be rendered consistent at an applied level - for example, the formulae for calculating days of delay or the handling of guarantees - more rigorous thresholds would risk exacerbating the phenomenon in countries, such as Italy, where the concept of "default" is already very severe, while leaving the situation unchanged in countries in which certain "pathological" situations are not regarded as "default" (consider the case of fully guaranteed loans). The rules to be followed for these technical, yet still substantive issues, need to be clearly established.

Q3. How much time is necessary to implement the threshold set by the competent authority according to this proposed draft RTS? Given current practices, what is the scope of work required to achieve compliance?

Even if the Italian Banking Association's proposals were to be accepted, the proposed changes would have substantial operating impacts at both the operational and technical levels:

1) operational: once the scope of past-due positions has been expanded, it will become essential to verify **impacts on management procedures for monitoring** positions already past due, and/or nearly past due, as well as to plan efforts to oversee the transition. The time required to make changes to the calculation of the materiality threshold would be considerable, since it would be necessary to **create entirely new procedures for managing an absolute threshold, which currently does not exist**.

2) **changes to internal IRB models and, more generally, credit risk measurement systems**: it will be necessary to verify impacts on risk parameters and, in some cases, to revise them. A distinction must be drawn between banks that use the standard approach and banks that use advanced approach (and, in the latter case, a further distinction between foundation and advanced approaches). **We suggest an impact analysis** to be extended to the entities affected by the regulations to evaluate the impact on capital ratios before planning to make the regulations operational. Turning to the issue of the impacts on the risk parameters of IRB models, it would be advisable to understand whether there is a need to reconstruct the entire historical series, or whether the changes can be adopted at later junctures (for example, since 2012, the year of adoption of past due 90 in several countries).

3) **IT work** required to adopt the new methods for determining past due and implementing changes to systems and models relating to the two previous points.

The adjustment time envisaged in the EBA standard **(two years) appears too short, especially for IRB banks**.

Therefore we ask for at least **five years** in order to achieve a full **adjustment of PD models** (even if not for capital requirements determination) also in the light of other pieces of second level rules that are currently under discussion at the EBA/EU level.

Q4. Do you agree with the assessment of costs and benefits of these proposed draft RTS?

Given that there do not appear to be any benefits, it bears emphasizing that the proposed draft RTS gives a misleading representation of defaulted borrowers.

We believe that the impacts of considering positions that exceed just one of the two thresholds have been underestimated. However, the option that minimises the impact is that which considers default to occur when a position exceeds both the absolute threshold and the relative threshold, and that uses a relative threshold on the upper end of the range currently employed.

Broadening the conditions for classifying a position as past due suggests reflection on the possible effects that may result in terms of the **procyclical nature** of credit supply, i.e. on the fact that the measure in question may increase the value of **the elasticity** with which the **credit supply curve** reacts to changes in the **real economic cycle**. In any event, there will have to be movement towards less room for discretion for banks in their handling of credit facilities for their customers.

For our purposes, it will be helpful to distinguish between two categories of disturbances of credit supply, depending on the point of origin of the disturbance: (a) those that originate within the banking sector, such as those that refer to capital shortfalls by banks, funding or liquidity difficulties and (b) those that originate externally to it, which in general are placed in the "borrower's balance-sheet channel" (decreasing the borrower's creditworthiness), but which, in this case, would be boosted by the regulations themselves (when modifying the criteria for classification as past-due).

All other things being equal, the proposed change will cause an upwards shift of the supply curve, due to greater costs in terms of the required regulatory capital, possibly an interest rate increase and surely impact on the profit or loss accounts of banks (and enterprises).

Now, once stated that the measure in question will tend to reduce the amount of credit (slowing expansion in the growth phase and accelerating contraction in negative phases) a proper view of the impacts of the proposed measure appears necessary to carry a specific impact assessment of such change in the elasticity of credit supply may have on growth.

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

The Italian Banking Association has conducted its own impact assessment on a sample of six banks/banking groups. **The main results are a significant increase in the number and amount of the positions** and the results are highly variable, as a function of the type of borrower.

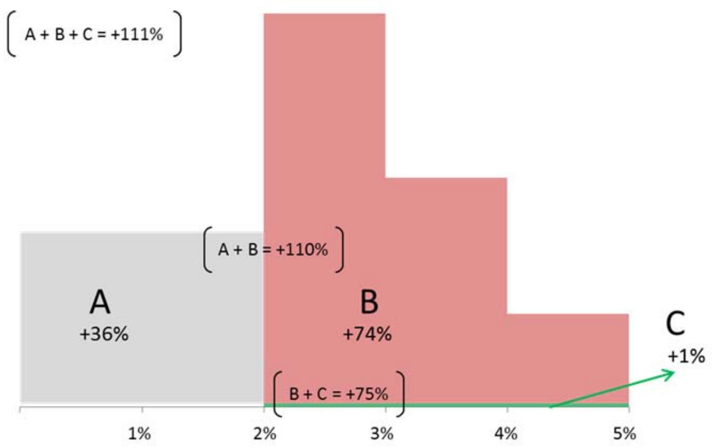
Hence a revision of the materiality threshold from 2% is needed.

Table 1 and Figure 1 show the percentage changes in past-due amount, in different what-if scenario.

Table 1. Components of the impacts of Options 1 and 2 *(change in % past-due at 30/6/2014 for a sample of six banks)*

Impact components	Δ past due amount	Area
Impact of the breach of the absolute amount thresholds (200 or 500 euros) alone	+110%	A+B
Impact of the breach of the relative threshold (2%) alone	+75%	B+C
Option 1: impact of the breach of at least one of the limits (absolute OR relative triggers default)	+111%	A+B+C
Option 2: impact of the breach of both thresholds triggers default (absolute AND relative triggers default)	+74%	B

Figure 1. Constituent elements of the impacts of the RTSs (*% change in past due positions at 30/6/2014, sample date*)



The areas depicted in the chart correspond to the percent increases in past-due amount (compared to existing levels) as a function of the components considered (see also Table 2).

It is possible to sub-divide the impact of Option 2 as a function of threshold levels. As expected, the analysis of the sample indicates that higher relative thresholds correspond to lower impacts.

Table 2. Break-down of the B area

Relative threshold range	Δ past due amount
2% - 3%	+31%
3% - 4%	+26%
4% - 5%	+17%
2% - 5%	+74%

A reduction from 5% to 4% results in a +17% change in past-due positions.

A reduction from 5% to 3% results in a +43% change in past-due positions (17%+26%).

A reduction from 5% to 2% results in a +74% change in past-due positions (17%+26%+31%).

These different values are represented by the "steps" in area B of Figure 1.

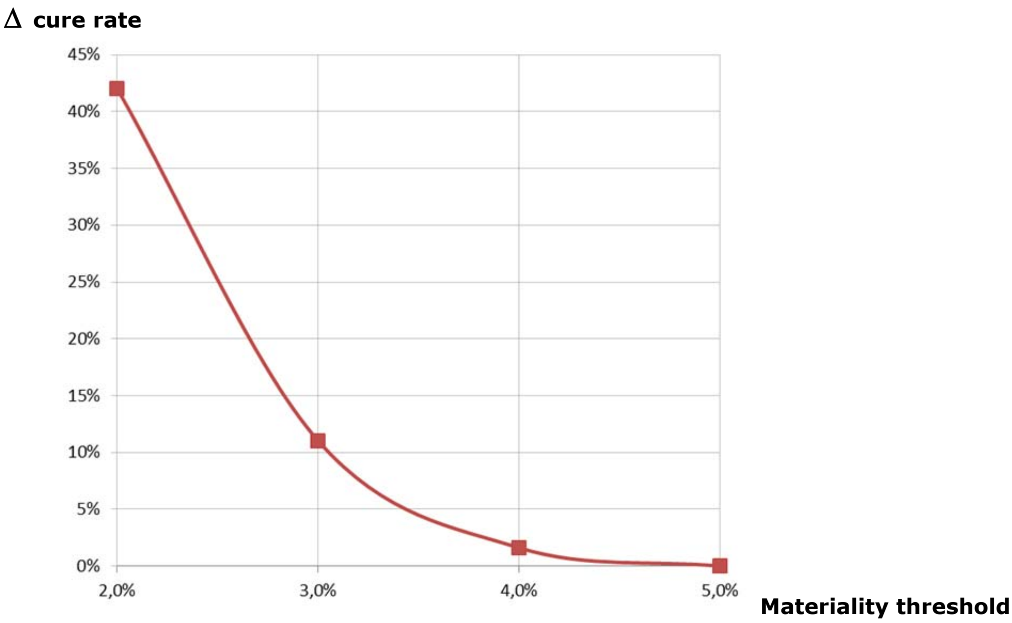
It thus bears emphasizing that even a threshold of 4%, twice that proposed by the EBA, results in a significant increase in past-due amount. This value must therefore be revised, including with the aim of avoiding an outright discontinuity in the historical series for the phenomenon.

The survey shows significant negative effects on cure rates. Figure 2 illustrates an analysis within the sample in which, for the "new" past due on 30/6/2014, the 30/9/2014 cure rate levels are presented.

In detail, decreasing the threshold from 5% to 2% would have resulted in an increase of over 40% in past-due number of positions restored to performing status; yet even had the threshold been decreased to 3%, the cure rate would have increased by more than 10%.

An increase in the cure rate is also present at the 4% threshold level.

Figure 2. Cure rate (three months later) for positions reclassified as past-due following the application of the RTSs



The change in the cure rate (compared to the current level) increases as the relative threshold decreases.
The X-axis shows the percent threshold level and the Y-axis the additional cure rate resulting from the application of the RTSs.

It bears emphasizing that the considerable increase in cases of "false positives" - due to the reduction of threshold levels - would also entail significant impacts on **customers' reputation**.

The combination of an excessive increase in past-due positions and cure rates, resulting in instability and relationship problems with customers, is thus strongly in favour of setting the relative threshold, in the context of Option 2, at least at 4%.

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With respect to **banks capital ratios the impact stems from 2 channels**:
1) **RWA**: the lower the materiality threshold, the higher the level of defaulted exposures in the asset class where higher risk weights are assigned;
2) **Provisioning**: these changes would entail for institutions applying both Standardizes and IRB approaches a significant re-calibration of all risk

parameters (e.g. PD) used for computing the impairment provisioning, both individual and collective, with a relevant increase of them.

The "qualitative" impacts are tied to the change in PD and LGD models (due to both the external change in the concept of "default" and the resulting revision of internal rules for identifying technical past-due positions), which will require a minimum of five years to be implemented. In addition, the impacts on operations are related to increased volumes in default and the implicit volatility of such positions in default.

Finally, attention should be drawn to the impacts on IT systems due to adjustment of IT infrastructure in compiling financial statement data, supervisory reporting and ordinary credit management.