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Die Deutsche Kreditwirtschaft

Comments

EBA draft revised guidelines on the definition of default

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for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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GBIC comments on draft EBA GL on definition of default

General comments:

The definition of default was fundamentally revised only a few years ago. This meant that institutions had to make significant changes – in particular, adjusting the relative days-past-due thresholds and the stipulations for ending the default status. This was not only due to the revised definition of default, but also due to the need to adjust the IRBA model accordingly and, as a result, the extensive examination that needs to be carried out by the supervisory body.

The proposed amendments could yet again lead to considerable effort for the institutions. And particularly if the institutions make use of their right to choose to recognise defaults at the individual contract level. Making use of this right results in a bigger difference between the NPE definition and the definition of default (see question 4). The amendments being consulted on here almost fully align the NPE definition with the definition of default – the only exception is the 'pulling effect' in the context of identifying NPEs. It is not clear why the differences between default and NPEs continued to be permitted in the last revision of the definition of default, only for them to be reduced just a few years later. There is no compelling reason why these terms should be aligned. These amendments would lead to greater implementation effort for the institutions – whereby it should be noted that possible risks arising from a differentiated definition of default and NPE are already covered through regulations on the NPE backstop.

In addition, it would be important that the simplifications from the revised RTS on assessing the materiality of changes to internal models (assessing the materiality of extensions and changes of the IRBA) were to come into force before the revised guidelines on the definition of default.

Comments on leasing

The current simplifications and exceptions in the EBA Guidelines on Default do not sufficiently take into account the specific characteristics of leasing business conducted by undertakings that belong to a supervised group. This leads to lessees with creditworthiness ratings of good to medium often having to be considered defaulted according to Article 178(1)(1) letter b) CRR and therefore as non-performing according to Article 47a(3) letter a) CRR. In terms of the risk profile of the lessee, this is a misclassification. This leads to unreasonably high levels of defaulted and non-performing loans in COREP and FINREP, significantly higher capital requirements for these customers since value adjustments are not taken into account and also to questions being raised by the competent authority.

This issue is further compounded by the categorising of operate leasing companies that belong to a supervised group as ancillary services undertakings and therefore as financial institutions. In many cases, leasing companies that belong to a supervised group often conduct both finance leasing and operational leasing.

Taking into account the "> 90 days due" reason for the default when validating the rating systems is not possible. Customers regularly pay late for understandable reasons that are rooted in the specific characteristics of the leasing business (see below). It should be noted

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here that leasing companies belonging to a supervised group compete with unregulated leasing companies and leasing companies that are supervised and must meet economic capital requirements under Pillar II, but are not subject to the rules of the CRR. There are only limited options to amend processes without suffering from competitive disadvantages.

Delayed leasing payments may be the result of lessees transferring leasing invoices after more than 30 days. This leads to overlapping defaults. If the lessee delays payment by more than 30 days, after several instalments, they will eventually be more than 90 days due. There are a variety of reasons for payments being delayed. Firstly, it is common for invoices to be checked before they are paid and the process simply requires a certain amount of time until payments are authorised. In particular, this applies to new leasing agreements. There are often questions from the lessee and payments are only authorised when all the questions are considered to have been sufficiently answered and the amount on the leasing invoice is correct.

Delays are especially common when it comes to invoices for final leasing payments and the leasing object has suffered damage. In these cases, there is often disagreement as to whether it should be considered normal wear and tear or whether it is indeed damage. There are also often disagreements about the amount of the damage as determined by the claims assessor. Lessees are then not prepared to pay for the damage or the amount of the claim. In order not to sour the customer relationship, there is then usually a period of negotiation with the aim of coming to an agreement. This is a very detailed business process and is conducted for each leasing object and leasing agreement. These negotiations often take time and are part of the operative leasing business. The internal audit department is not regularly involved in this process. However, this is e-mail correspondence, which must be kept for several years in accordance with commercial legal stipulations in order to maintain transparency about the reason for the delayed payment, also in case there is an audit by the supervisory body. Once an agreement has been reached with the lessee about the amount of the claim for damages to the leasing object, the lessee will then generally transfer the final due payment very quickly.

Given the issue outlined above, we would ask for an amendment to the EBA Guidelines on the definition of default since the current simplification is not practical and does not reflect standard operating practice. We would also request an addition to take into account more appropriately the specific characteristics of the leasing business:

Proposed amendment:

paragraph 19(b): *"in the specific case of leasing, ~~a formal complaint has been directed to the institution about the object of the contract and the merit of the complaint has been confirmed by independent internal audit, internal validation or another comparable independent auditing unit.~~,* ***there is disagreement regarding the object of the contract or the amount of the final payment of a leasing contract when the leased object is returned."***

Proposed amendment:

Paragraph 23**(g): *"In the specific case of leasing, where the materiality threshold set by the competent authority in accordance with point (d) of Article 178(2) of Regulation (EU) No 575/2013 is breached but none of the receivables to the lessee is past due more than 60 days."***

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Specific answers

Question 1: *Do you believe the current guidelines result in some exposures under forbearance measures to be incorrectly classified as defaults, thus hindering proactive, preventive and meaningful restructurings given the detrimental effects that defaulted status has for the affected obligors? If so, please further specify the characteristics of the exposures, which you deem as being subject to an incorrect classification of default.*

Yes, the guideline can lead to exposures under forbearance or even after forbearance being incorrectly classified as defaults.

In general, a loss in net present value can already occur through interest deferrals or through repayment deferrals without this resulting in any real danger of a default on the corresponding position and/or these deferrals can serve as restructuring measures, which reduce the probability of default. A forbearance measure that is suitable for preventing the actual default may therefore lead to regulatory classification as a default under Article 178 CRR.

Given the detrimental effects of the default status on the affected obligor, this could hinder any proactive, preventive and meaningful restructurings. The commitments that are incorrectly categorised as defaulted as outlined above should therefore be exempted. In such cases where obligors have a positive going concern prognosis, the 1% threshold for net present value should, at the very least, be increased significantly.

In retail business, short-term backlogs may occur even after restructurings with appropriate forbearance measures. In the case of monthly payments, instalments may be 30 days past due in months with 31 days, if the unpaid instalment (usually paid monthly) is debited on the next due date for procedural simplicity. According to the rule being proposed, this would not only lead to a forborne NPE but also to a default. If the default were to reoccur, default processing would resume immediately, although no further measures could be taken at this stage due to legal regulations (only an initial reminder).

In our view, the current requirements for ending the default status, "restructuring/debt rescheduling" – in particular the "365 days not overdrawn" requirement – are too restrictive. This rule would lead to commitments that have actually stabilised continuing to be considered defaults. In our opinion, the following distinctions should be taken in account:

- Short-term overdrafts: In cases where overdrafts are only very short (e.g. for a few days each year), there should be a grace period. One example is a delayed payment due to internal booking days (Friday vs. Monday), which lead to an account being overdrawn for only three days, while all remaining payments are made on time.
- Small overdraft amounts: De minimis amounts should also not lead to a continuation of the default status. There are already analogue rules for the definition of "90 days past

due". A threshold of €100 seems appropriate so as not to overstate the minimal overdraft fees or small overdraft amounts.

Neither situation is a 'first-class' creditworthiness case, nor are they final defaults with irretrievable exposures. However, the current regulation distorts the picture by also classifying commitments that are economically viable again as defaulted.

Since the termination of the default due to "restructuring/debt rescheduling" is subject to manual review anyway and the relevant basic characteristics (3501/3511) indicate both the amount and duration of the overdraft, the introduction of grace periods or de minimis amounts could easily be implemented in practice.

We would like to suggest including the type of default in the new wording of paragraph 54. The new paragraph 54 no longer refers to the default classification as "distressed restructuring". This could result in ambiguities with regard to recovery criteria and phases. While, in the old version, the default type was explicitly given as "distressed restructuring" for forborne non-performing (which leads to specific requirements for recovery criteria and phases), in the new version, this is only apparent in relation to other paragraphs. We would therefore like to propose adding the following for clarification:

"All exposures classified as forborne non-performing in accordance Article 47a of Regulation (EU) No 575/2013 should be classified as defaulted ***as "Diminished financial obligation due to a forbearance measure"."***

Question 2: *Do you think that relaxing the criteria for the minimum period before returning to the non-defaulted status for defaulted forborne exposures could be an appropriate measure to alleviate a higher burden on your institution and clients? How material would the difference be in your case between the amounts of forborne exposures classified as NPE and as defaulted if the minimum one-year probation period in the definition of default were reduced to three months for certain forborne exposures (with change in NPV below 5% and no loss on the nominal amount)? Would that proposal create additional operational burden or practical impediments? Do you see support such proposal, and if so, for which reasons?*

The proposed reduction to the probation period for net present value changes below 5% would lead to significant additional procedural/technical burdens. This applies, in particular, because this results in a deviation from the definition of NPE, which, at the same time, has no effect due to the new paragraph 54. In addition, this results in another audit/documentation step as it needs to be determined whether net present value is lower than 5%. Not least, by reducing the probation period, the risk of multiple defaults increases.

Nevertheless, the one-year probation period appears inappropriate in some cases. According to the current regulation, any agreement to remedy an overdrawn account must be considered a

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forbearance measure as long as it is implemented 90 days past due. However, if this measure results in the default being resolved in the short term, a one-year probation period seems inappropriate.

The probation period should only be reduced if, at the same time, the NPE definition is amended accordingly. In order to avoid extensive net value calculations, qualitative criteria should be used to identify loans whose probation periods can be reduced. For example, smaller interventions – such as capitalising arrears – a 3-month monitoring period, more major interventions – such as restructurings in a new account – a 12-month monitoring period. Furthermore, a reduction should only occur in the case of "restructuring/debt rescheduling" and if, in individual cases, the following additional conditions are met:

- the "debt rescheduling/restructuring" reason for default is solely due to the accorded forbearance measure
- the only additional reason for default is "payment default/overdraft > 90 days"
- and the probation phase for this reason for default has already automatically ended after the proscribed minimum period of three months

In this case, an automatic check should also be carried out after three months for the default reason "debt rescheduling/restructuring" – analogous to the requirements for the default reason "payment default/overdraft > 90 days".

Question 3: *Do you see any alternatives other than those referred to in this section that the EBA should consider under Article 178(7) CRR to update the Guidelines and encourage institutions to engage in proactive, preventive and meaningful debt restructuring to support obligors?*

What would definitely make sense is for the position not to be considered defaulted during the probation period in accordance with paragraph 71 of the guidelines. Otherwise, the following problem would occur: By resolving the risk provisions, the reason for the default no longer applies and the probation period begins (paragraph 71a GL, Article 178(3b) CRR). If the position is defaulted, it is also non-performing (Article 47a(3a) CRR) and therefore relevant for the backstop regulation. When the risk provisions are resolved, there are also no changes to the deadline calendar according to Article 47c CRR because the position remains non-performing, so the position can lead to a backstop deduction due to the lack of coverage (risk provisions, Article 47c(3b) letter i CRR). This result would not make sense because the resolution of risk provisions is justified on its merits and does not therefore represent a deficit that needs to be covered by a backstop.

Question 4: *Do you use internal definitions of default and NPE that are different from each other? Which differences are these and how material are those differences? Do you have any*

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reasons or observed practical impediment that warrants a different definition of NPE and default? If so, please provide examples where a different definition of NPE and default is appropriate?

There are institutions that use a different definition of default and NPE in retail banking. In particular, due to better modelling at the individual contract level, the option can be taken to define the default at facility level. A further alignment of the two definitions would undermine the right to choose between the two under the CRR. If there were to be an alignment of NPE and default, the NPE definition should be aligned with the default definition and not vice versa.

Question 5: *Would a potential lack of alignment between the default and NPE definition lead to issues in accounting in your case?*

Aligning the default and NPE definition would certainly make many things a lot easier. However, the status quo of different requirements is better than aligning the default definition with the NPE definition. The optimal solution would be to align the NPE definition with the default definition (and not vice versa).

Question 6: *Do you agree that no specific provisions should be introduced for moratoria on the grounds of the sufficient flexibility of the revised framework? In case you think the proposed alternative treatment for legislative moratoria should be included in these guidelines, do you have any evidence of the definition of default framework being too procyclical in the context of moratoria? Do you agree with the four conditions that need to be satisfied?*

We agree. A dedicated rule of this kind is not necessary. If a legislative moratorium is introduced, then there is a legal basis for it. This can then also legislatively regulate the points mentioned in the proposed paragraphs 115 ff for the specific moratorium.

The proposed clarification in case of legislative moratoria is also unnecessary and rather confusing, in our view. We therefore suggest not including it.