EACB Comments

EBA draft Guidelines on the definition of default

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Introduction

The members of the EACB welcome the opportunity to comment on the EBA draft GL on the application of the definition of default under Art. 178 CRR.

General comments

We understand the aim of the GL to promote harmonisation of practices to ensure increased consistency of risk management models, a level playing field and more efficiency for cross-border groups.

However, we note that some flexibility should be maintained giving sufficient room to expert judgment for the definition of default. The definition of default is a truly sensitive element: proposals need to be thoroughly calibrated to avoid disconnecting the prudential status of the default from the economic reality of the counterparty. This would conflict the "use test" of the Basel framework. It would be more risk-sensitive to keep a flexibility expert judgment for specific cases. In addition, while harmonization of supervisory rules and practices can be a justified goal in the Banking Union, not all definitions and practices can be harmonized due to national peculiarities and legislative differences.

Moreover, such harmonisation should not disregard developments coming from other regulatory streams to ensure consistency also within institutions. The proposed guidelines should not propose definitions that are in contrast with IFRS 9. The EBA draft GL seems in several instances even in contradiction with the upcoming IFRS 9 (e.g. symmetry of transfers between IFRS 9 stages and the implementation of the cure period in the CP, treatment of forbearance, non-accrued status, days past due). Concerning the days past due, for instance, the IFRS9 standard uses the term 90 days and more past due (90+) while the consultation paper and Art. 178(1)(b) CRR refer to 'more than 90 days past due' (91 +). While this may seem a minor difference, it can increase the complexity and is relevant also for other past due/overdue disclosures and triggers, more alignment in this sense should be sought with the IASB. Even if it is possible to use different definition of default for accounting purposes (IFRS 9.B5.5.37) than for regulatory purposes, banks are trying to avoid complexity and confusion by aligning these two definitions as both of them has to comply with the credit risk management of the bank. Even the Basel Committee recommends that the definition of default adopted for accounting purposes is guided by the definition used for regulatory purposes.

Impacts and timeline for implementation

The impact of the proposals will clearly vary depending on the degree of proximity of existing and implemented practices. However, it can be surely envisaged that a sufficiently long implementation period is needed for institutions to perform for instance recalibrations of internal models (where the case) and successive supervisory approval, adaptation of IT systems (for both IRB and SA institutions), overall change of practices and databases and so on.

Given the rest of the EBA schedule (as mentioned in the Future of IRB approach), several proposals may seem minor, but taken together have a substantial impact when implemented. In particular, for banks spread over a large geographical area, it is quite resource-intensive to implement some of the proposals since some information is not collected on that local level, implemented in local/central systems or submitted to central systems. We believe there is a need for some leniency and timelines could be more effectively agreed upon between the supervisor and the financial institution.

Retrospective application of the default definition as per the draft guidelines would hardly be possible. The introduction and implementation of the new guidelines imply that corresponding data histories of the default time series would have to be accumulated before they can be used as an anchor point in the rating procedure. In the transition phase, during which the new guidelines on default definition will have already been implemented but no data histories of sufficient length are available for validation or calibration, institutions should be entitled to adopt a flexible, albeit fully justified approach. This is coupled also with changes deriving from the draft RTS on Materiality Threshold. Existing default time series used to develop, validate and calibrate all the PD, LGD and EAD rating systems will have to be adjusted quite significantly. Since this cannot be implemented retrospectively, it will take some 1 to 2 economic cycles (five to ten years) before this is completely rectified.

Where IRBA rating systems are used, these changes are likely to need submission of models for supervisory approval. Since the further development of the models is not linked to adjustments inherent to bank portfolios, the imposition of penalties, e.g. in the form of conservatism mark-ups, would be unjustified. The requirements for approving significant changes in rating procedures could be revised (para. 12 of the draft GL) in order to provide for more flexibility. Also, the implementation periods need clarification. Para. 13 of the draft GL indicates that applications for supervisory approval of model changes have to be submitted at least one year before the draft GL come into force. However, we see that the change to the risk measurement models can only be gradually determined by institutions, while all the implications of the revised definition are explored, thus such application should not be made subject to a hard deadline but be adequately agreed upon by institutions and supervisors.

In any case, in order to minimize the operative impact it is also important to coordinate the entry into force of the new definition with the IFRS 9. The new rules on the definition of default should not enter into force before the mandatory application date of IFRS 9. At the very least, indications provided in the "Future of the IRBA" (adoption of the draft GL by mid-2016 and 2.5-year implementation phase) should apply.

Materiality thresholds

While the materiality threshold was addressed under a separate consultation, we have noted the inclusion of a scenario in the QIS that assumes application of an absolute threshold of € 200 for retail exposures and € 1000 for non-retail exposures and a 2.5% relative limit for non-retail exposures. While we appreciate that certain concerns of the industry have been taken into account, we believe that the 2.5 % relative threshold is still too low. In line with our proposal for the draft RTS on materiality threshold, we believe a 4% threshold would be more appropriate. In addition, applying only an absolute threshold for the retail exposures holds a potential for undesirable impact in particular on SMEs portfolios. Also we believe the past due amounts could be compensated with unused general credit lines for the same debtor. This possibility would allow avoiding considering as defaults cases where a customer has past due amounts on a line of credit and available margin on another one. In these cases the anomaly in the payment structure is likely to be due to a non-optimal position management. This would also be in line with the counterparty level approach followed by this consultation.

Probation period for return to non-default status

With regard to the proposed probation period for return to non-default status, we believe that counterparties should instead move to the non-default as soon as the obligation is paid in. This is particularly crucial for default trigged by past due. The current proposal might trigger unintended impacts on credit risk bureaus and on relationship with costumers registered on them. The suggested 3 months' probation period is also too long in relation to both large corporate exposures and retail consumers in particular when applied together with the strict definition of the technical default as proposed in the draft GL.

Development banks/Promotional loans

With regard to development-related business in some Member States, development banks frequently grant loans to final borrowers via a commercial bank which channels the loan to the borrower. Depending on the type of development loan involved, the on-lending commercial bank or the development bank bears the default risk. In numerous development loans the on-lending commercial bank and the development bank share the resulting losses. In that case the development bank faces two risk positions: one against the final borrower and one against the on-lending commercial bank. Development loans serve a narrowly defined development purpose. If the final borrower cannot prove compliance with the development purpose, the loan has to be repaid. If he is not in a position to do so, this raises the question as to how the loss will be shared by the development bank and the on-lending commercial bank. In such cases, legal disputes may even ensue and the on-lending commercial bank ends up in payment default with the development bank because of the legal action. This leads to particular problems in the definition of default in IRBA. If the final borrower defaults, then the development bank might have to classify the entire loan as level 3, even though the on-lending institution is still solvent. In our opinion, this case should be included in the list of exceptions in para. 28, so that the development bank only has to treat the exposure to the borrower as defaulted.

With regard to probationary periods, sometimes a borrower of a promotional loan ceases to meet the criteria under which the loan was granted and is moreover unable to repay the loan. In these cases, a dispute may arise between the development bank and on-lending institution over the question whether the criteria for the development loan are met or not. If then the on-lending institution is unjustly considered "defaulted", it might then return to non-defaulted status only after a 3-month probationary period. This might be further complicated by the fact that due to the numerous exposures granted via the one institution, not all of the development bank's exposures to that on-lending institution are repaid. In that case, the exposures to the institution could also be considered "restructured". This would mean that the probationary period is prolonged to one year. We would argue that a return to non-default status should be possible immediately and without a probationary period, if the default cannot be attributed to the debtor's creditworthiness problems.

Elements for clarification

Certain elements could also be further clarified. For instance the reference to the overall level of leverage of the borrower should be qualified more precisely, in order to better assess the scope and extent of the indicator, or to identify it as a rebuttable trigger. It would be counter-intuitive to be penalized for funding a client that has improved its credit quality albeit with higher leverage.

With regard to the counting of past due it is indicated that the historical counting should be done on a daily basis. This type of metering implies a strong potential for volatility of results and it can generate very heavy IT charges to properly account exposures to customers/debtors, particularly for factoring. Moreover, for some banking products such as mortgage loans, the determination of default is performed at the end of each month. A monthly basis calculation with month-end only would be sufficient and more appropriate.

Finally, while it was not explicitly addressed in the proposed draft GL, how to deal with repayment of arrears and how these affect the materiality threshold is a key question. In particular, we would propose a FIFO approach where the “oldest” arrears are offset against the new repayments.

Answers to selected questions

Q.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.

We have some concerns that not all non-financial circumstances such as commercial disputes are resolved within the first 90 days.

Ideally, some expert judgment should be introduced in determining the technical defaults or for exceptional circumstances, including proper documentation. In particular for CGCB and public sector entities there is often a delay in payment which is not associated with default. Considering technical defaults only due to personal or system errors could be acceptable, however it is not clear whether such indication would need to be explicitly stored as such in the central systems (technical defaults), that would in fact imply a relevant implementation burden.

Moreover, the definition of technical default is in a way too restrictive: all non-payments not due to credit reasons are considered defaults with the exception of the cases under para. 20(a),(b) of the draft GL.

This would imply in many cases major changes from the current practice of non-retail activities where no definition is given and where expert judgment is used to determine whether a past due status relates to a technical default or not.

The approach proposed by the EBA requires a much broader definition of qualified technical default situations, e.g. resulting from the exposure past due more than 90 days but not due to credit deterioration of the counterparty.

We believe that there are a number of other situations that could be added to the cases of technical default, as they are not connected to a credit deterioration of the counterparty:

- commercial litigation with a client in the case of the leasing business where the quality of product/service rendered is disputed;
- lengthy administrative procedures to authorize payment (e.g. for local authorities);
- logistical issues for energy and commodities funding or more generally for financing of trade finance deals (for instance among reasons that lead to delivery delays: the goods are blocked at customs, prohibition to enter or to leave ports);
- disputes regarding the amount or nature of the collateral in the event of margin calls;
- sovereign counterparties, for which default should be assessed at the political level;
- cases of "force majeure" (environmental disasters, measures imposed by law[1], riots, strikes, wars).

In addition, trade disputes are resolved over long periods (often several years) which would mean that the borrower in default would remain so throughout the entire period.

When implementing the proposed definition of technical default, it should be borne in mind that individual institutions could be confronted with considerable IT and procedural implementation costs. Technical identification could result in an undesirable change in default status. For example, after the occurrence of the default event, it has to be established whether the customer rendered payments which were not taken into consideration in time. In that case the default event has to be reset manually after the review. The resulting high effort would be unjustified in view the low materiality of technical defaults. Even though the proportion of technical defaults is low, all the defaults would, nevertheless, have to be analysed. Thus, non-consideration of technical defaults should be left as an option available to financial institutions.

[1] We note that this concept is captured in the para. 3.2.1 of the Rationale of the GL but not explicitly in the text of the draft GL.

Another risk of this definition is too restrictive to reduce the relevance of the models and reduce the incentive to "use test". This is likely to significantly increase the default rate and therefore the “expected” cost of risk in the bank, so the market clients conditions

Moreover, while the EBA proposes that a technical default is limited to error in data or IT system of the institution (page 7 point 3.2.2), a technical default could also be the result of error in data or IT system of the counterparty, particularly for large corporates. This could have an impact on both credit risk modelling (issues finding relevant risk drivers) and the reasonableness in reporting of large exposures (risk of reporting large well known counterparties as defaulted due to error in data or IT systems).

With regard to requirements under para. 11(a), we believe that this would be hardly possible without lengthy and extensive manual work to adjust historical data for default definition. In line with transition to IFRS 9 where no comparative information is required, these guidelines should be applied prospectively.

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

With regard to para. 23, it is sometimes contractually agreed that after the risks and rewards are fully transferred to the factor, the transferee continues to service the receivables and the original debtors may not have been notified of the transfer. Even if the original debtor had paid in time, the transferor may not pass the amounts collected to the factor, or the amounts collected are agreed to be transferred in one instalment at certain dates rather than one by one. These kinds of situations or other commercial disputes could cause a "technical default" and therefore a relief from counting the days past due for factoring contracts should be considered.

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

We stress again the importance of having the implementation of the new default definition not before mandatory date of IFRS 9. This would limit the huge costs, from an operational perspective, to adapt the new definition of default to current accounting practices and shortly after to the revised IFRS 9 principle.

Generally, Stage 3 of IFRS 9 includes exposures that are credit-impaired (e.g. in case of significant financial difficulties of the debtor, breach of contract, concession due to financial difficulties, the probable bankruptcy of the borrower etc. However, the condition that all exposures classified as ‘Stage 3’ under IFRS 9 are treated as defaulted should be applied in a more flexible way, otherwise it may prevent from reclassifying in performing status some asset typologies like purchase or originated credit impaired (POCI) assets, which according to the accounting principles remain in Stage 3 also after having being restructured. POCI are treated differently because they are credit impaired at initial recognition. According to the accounting principles of IFRS 9 under certain conditions the POCI must remain in Stage 3 for their entire maturity regardless of their credit recovery and performance also if they could be classified as performing. Hence, we would suggest that the EBA's guidelines embed a Stage 3 definition as it will be adopted in the relevant accounting operative rules avoiding automatism between stage 3 and default.

Also, while most of the exposures in default would end in Stage 3 under IFRS 9, the reverse may not be automatically true. There could be situations where some Stage 3 are not in default defective, for example when national options exist, but also for some technical defaults (see also Q.1).

Furthermore, while we welcome the clarification provided by the EBA that losses "incurred but not reported" should not be considered as an indication of unlikeliness to pay (para. 26), this clarification should also include Phase 2 of IFRS 9 that shall not be considered as defaulted.

Moreover, the exclusion of not yet incurred losses from the default recognition is reasonable given that there is here no indication yet of an actual default event. General individual valuation adjustments or value adjustments without any consideration of a specific case never serve as the basis for default. For instance, general loan loss provisions (GLLP) or portfolio loan loss provisions (PLLP) for non-impaired items cannot be understood as default criteria.

For exposures recognized at fair value and whose value changes are taken to the income statement, we consider it to be inappropriate that impairment alone results in default. On the one hand, in principle only the credit-risk induced portion of an impairment would be relevant.

A clarification could also be provided with regard to suggested probation periods for exposures with incurred partial losses.

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

We do not believe that this indicator is appropriate. The sales of a credit obligation at a loss could happen for other reasons than credit risk deterioration, such as liquidity management, regulatory capital and balance sheet management or single limit concentration reasons. A credit related loss cannot be unambiguously determined by IT systems.

Also the threshold identified seems overly restrictive, as a simple reduction of 5% of the nominal value would induce a default of the debtor, with possible contagion effects linked to its other exposures within a banking group. Moreover, recent markets' history has showed that when financial markets are highly volatile, some bonds could be under 95% of their par value only because markets anticipate a future decrease of the credit quality without the issuer being itself in default. For instance, even the case of a rating downgrade does not automatically mean the exposure is in default: there is still a large room to manoeuvre within the investment grade (or non-investment grade) until it reaches default.

A sale below 95% of value can easily occur on non defaulting exposures, e.g. for long-term, low-interest assets, if the counterparty default risks cannot be estimated precisely by the contractual partner.

Also, we understand from the formula in para. 33 that the starting point would be the outstanding amount of the obligation with accrued interest and fees. The difference between the outstanding amount of the obligation and the sale price involves not only credit related aspects but also many other components which as a rule cannot be unequivocally identified. For instance, even a long-term fixed-rate agreement below the prevailing market rate for the exposure to be sold, for example, would normally lead to a present value mark-down and thus to a reduced selling price of less than “E”, without the current creditworthiness having necessarily deteriorated compared with that when the loan was granted.

The minimum threshold should be raised at least to the level of 10% and expert judgment included in the assessment. So that even if the criterion is used as indicator of unlikeliness to pay it is combined with other elements.

Moreover, in the case of a portfolio sale with collectively determined purchase price, all borrowers in the portfolio might be considered defaulted, if the collective loss or purchase price discount is below the proposed threshold. There is a risk that numerous borrowers in a portfolio of heterogeneous credit ratings would be considered defaulted, even though individually they have not suffered any value loss at all. This leads to additional distortions in the historical time series and to further current misclassifications of affected borrowers.

Finally, we believe that requirement to store the loss for risk parameters creates undue complexity and possibly distorts risk statistics. Also para. 36 presents relevant difficulties, as all the remaining exposures of the obligor would be treated as defaulted only because of a sale of one obligation at loss. Additionally, following the requirements in para. 37 would be very complex and require essentially manual work.

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

Cash flows should be discounted with the customer’s original effective interest rate. In any case, financial institutions which do not apply an effective interest rate under the accounting standards relevant to them should be given an opportunity to use other discounting rates in line with the institutions' economic management instead of the effective interest rate.

The specification could however be clearer regarding how to handle any situation when the original effective interest rate is not available or in case of variable rates. On the other hand given current market conditions, characterized by low interest rates, the application of the interest rate at the moment of the renegotiation might be preferable.

The EBA could provide a clarification to understand the rationale according to which the customer's original effective rate was chosen.

Additionally, if the contractual cash flows on a financial asset have been renegotiated or modified according to IFRS 9.5.5.12, an entity shall assess whether there has been a significant increase in the credit risk of the financial instrument. This assessment does not automatically lead the asset to be in stage 3 or to be considered as defaulted. We believe that the default criteria should be aligned with IFRS 9 and not by setting artificial thresholds to evidence default.

We also believe that para. 43 of the proposed GL, (i.e. all non-performing forborne exposures are classified as defaulted) should be deleted as it seems to contradict with section 5 Accompanying documents, "Alignment with supervisory reporting framework" (pag. 52) where option c is preferred i.e. non mandatory alignment of definition of default with "non-performing".

Under IFRS a loss is recognised separately and the book value is adjusted for the "forbearance loss". Consequently IFRS 9.5.5.12 states that the institutions shall assess significant increase in credit risk by comparing the risk of a default occurring at the reporting date (based on the modified contractual terms). For that reason forbearance measures that diminish the cash flows of the contract do not necessarily automatically result in a credit impaired status (default status) under IFRS 9.

The 1% threshold for the diminished financial obligation is thus too low. The measure for recognition of default should be set where the new cash flow (NPV) would no longer adequately cover the book value of the obligation.

In addition art 178(3)(d) CRR considers "material forgiveness […] of principal, interest or, where relevant fees". The proposed threshold does not seem consistent with the materiality criterion set by the regulation and should thus be higher.

We would also see no need for specifying additional indicators to be considered for identification of default if the net present value of expected cash flows on the distressed restructuring arrangement is higher that the net present value of expected cash flows modifications. In addition, we believe that the cash flows should be calculated at customer level.

Concerning the formula for calculation of the diminished financial obligation (DO), it is not clear whether the cash flows include the expectation of recovery. If they do not take into account recovery expectation, the threshold would not make much sense as the new restructured loan could include a reinforcement of the collateral value which might mitigate (partially or totally) the diminished financial obligation measured with the proposed formula.

Also, with regard to para. 38 of the draft GL, it seems that according to conservative interpretation the first forbearance measure triggers the examination obligation. Exceeding the formula threshold leads to a default with a minimum default period of one year. This policy would differ from the current obligation to trigger a default in case that after the first forbearance measure 'under probation' a default only occurs after the 30-days-past-due criterion or after the implementation of the second forbearance-measure.

This would lead to an increase in NPL-ratios and to an inappropriate extension of default periods. We have serious concerns about the above mentioned approach and therefore we believe that the current methodology should be maintained.

Finally, we would like to underline that the concept of distressed restructuring should not apply in case a revision of the conditions is allowed by the contract (e.g. embedded clauses) or by specific laws (e.g. moratoria issued by banking association/government) or to commercial renegotiations (e.g. change of interest rate for commercial purposes or alignment with current market practices).

Q.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?

The purchase or origination at a discount price of an asset cannot be deemed a criterion for unlikeliness to pay. The material discount could for example be the result of negotiations, changes to market conditions or very high LGD of the financial asset (low collateral value). In the event of an unlikeliness to pay for purchased or originated financial assets this should also be reflected in the PD for the obligor.

This proposal might trigger a default for reasons that are independent from the credit risk of the counterparty. Thus, it does not seem compatible with the incentive to use Basel parameters for assessing credit risks.

Also, it is not clear how para. 47(g) would differ from para. 30 concerning the sale of credit obligation. Further explanations would be needed and at least indication of what would be considered as "material discount".

Similarly to Q.4, 90 days materially past due and unlikeliness to pay should be investigated during the due diligence that must be performed. Since these exposures are purchased, any signs of default that occur afterwards are still observed (in contrast to selling the exposures to "avoid" the loss registration).

Q.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?

We believe that there should be no probation period for a return from default to non-defaulted status. A symmetrical treatment should be provided for exposures that are moving from non-defaulted category into default category and for exposures that are cured and moving out from default category to don-defaulted category. The same treatment is provided for in IFRS 9 where an asset can be transferred form stage 3 to stage 2 based on significant decrease in credit risk without probation period. Under IFRS 9 favourable changes in credit risk should be recognised symmetrically with unfavourable changes in credit risk (IFRS 9 BC 5.210). By applying a probation period, financial instruments would move into default quicker than back to non-defaulted status. This can result in exposure being classified as defaulted but not credit impaired under IFRS 9 (bucket 2 exposures) or the exposure would be classified as defaulted and credit impaired (in bucket 3) but with no loan loss allowance which is contra intuitive.

In addition, it would be very complex for reporting purposes to comply with a range of probation periods, i.e. those defined in points 157, 176 and 179 in EBA's ITS on Supervisory reporting on forbearance and non-performing exposures (as per Art. 99(4) CRR), and those introduced in the draft GL in para. 58-60. Although the probation period for distressed restructuring of one year is the same as in para. 157 in the ITS on forbearance and non-performing exposures, the definition of default and non-performing may not be the same. Therefore, no additional probation periods are needed.

Article 178(5) CRR also states that if the trigger for default no longer applies, the exposure/obligor should be rated as non-defaulted exposures/obligor, suggesting that there is no room for a probation period.

Counterparties being classified as defaulted could return to non-default status as soon as the obligation is paid in. This is particularly crucial for default trigged by past due. If left unchanged there might be unintended impact on credit risk bureaus and on relationship with costumers registered on them. Customers, especially retail one, might not understand and easily accept a rule that marks them as defaulted debtor after the obligation is paid (considering all the related consequences on credit application). Thus, the recognition when a customer is no longer in default should be up to each institution.

The suggested 3 months' probation period is also too long in relation to both large corporate exposures and retail consumers in particular when applied together with the strict definition of the technical default as proposed in the CP. In case of retail and SME customers, payments are not always fully automatized by systematic debit of the customer's account: a delay in payment does not necessarily mean a deterioration in the credit quality of the borrower especially if the cure period is short (less than 30 days).

The postponement of a due instalment and/or due interest and/or due fee towards the end of the credit period is not considered as an extension of the 'grace period' towards the end of the credit period. Should such postponement be considered as 'grace period' this would indicate that the 1-year-minimum period starts at the end of the credit period.

In case of distressed restructuring, we believe it is the assessment and expert judgement of remaining unlikeness to pay, that ought to be the determining criteria for a decision to return the exposure to non-defaulted status, not a minimum period of time.

However, if the proposed cure period for distressed restructuring will be maintained in the final GL, it is opportune to specify under para. 59 which repayment suspensions shall be considered as a "grace period". In particular, if a restructuring arrangement provides a temporary suspension of the sole interest share of the loan, it is not clear if that suspension shall be treated as a grace period, considering that the principal share of the loan won't be suspended.

Similarly, should a defaulted client of a bank be bought by another client of the bank (client B) that is not in default, the exposures of the client B should not be considered defaulted if there is no decrease in the credit quality of client B (due to the acquisition).

The remaining unlikeliness to pay should be the decisive criteria. Depending on the portfolio specific characteristics, there might be different or no probation periods.

For the purposes of para. 59 it seems that the application of criteria under para. 58 would be sufficient and more appropriate than a minimum 1-year period, thus enabling a restructuring before 1 year and still meeting the CRR’s aims. Moreover, the postponement of a due instalment and/or due interest and/or due fee towards the end of the credit period is not considered as an extension of the 'grace period' towards the end of the credit period. Should such postponement be considered as 'grace period' this would indicate that the 1-year-minimum period starts at the end of the credit period.

Finally, changing the treatment of probation period on historical defaults will be challenging in terms of recalibration of IRB models, especially if different probation periods should be applied for different types of default events. Proposed changes should be implemented only to defaults occurring after the implementation of the new guidelines.

Q.8 Do you agree with the proposed approach as regards the level of application of the definition of default for retail exposures?

We agree with the proposal, as we understand that an entity may choose the level of application based on risk management practices, although usually facility level would be most appropriate. We thus support that the credit institution may decide when to apply the default definition at obligor level and/or facility level.

Q.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 credit obligations of this obligor?

We disagree. In line with application of the definition of default for retail exposures at the facility level, the credit risk may be significantly different in different consumer products. For example a credit card receivable may be more than 90 days past due but the mortgage loan of the same customer can be fully performing. In our opinion a pulling effect cannot be automatically assumed if 20% threshold is exceeded but definition of default at obligor level requires expert judgement.

The fact that an obligor defaults on a significant part of his exposures, could be considered as additional indication of the unlikeliness to pay but it should not automatically indicate the unlikeliness to pay the remaining credit obligations of this obligor. There can be numerous cases where other exposures can still be repaid whereas the other exposure is in default (e.g. entrepreneur exposure on one side, support from spouse on the individual/consumer side). In some cases the identification of defaulted exposures within credit facilities is not clear, for example, when a payment of a home loan is automatically assigned to another credit institution. Some banking arrangements stipulate that some overdraft’s may be automatically offset by cash from another account. Legal confidentiality restrictions could also prevent the possibility of consolidating the defaults between different legal entities of the institution. This should be looked at on a case by case basis.

The pulling effect should not be introduced for retail exposures where the default definition is applied on facility level. The introduction of a pulling effect would diminish the purpose of applying default on facility level and would most likely reduce the predictability of PD models.

Rather, institutions could be asked to either demonstrate that a default on a single facility does not have an impact on the probability of default for other facilities to the same counterparty; or handle pulling effect as a part of the model specification, i.e. include the occurrence of a defaulted facility as an explanatory variable in the PD-model on facility level.

Finally, the rules for calculating past due days and the materiality threshold would be difficult to define and implement. The application of this approach would be operatively very expensive.

Q.10 Do you agree with the approach proposed for the application of materiality threshold to joint credit obligations?

This should be a rebuttable trigger as well. While it may seem workable in theory, there can be practical cases, where there are reasons for default for one facility not to automatically result in a default for the other. Such a mechanical and automatic process should rather envisage judgments and expert opinions.

If a joint obligation towards an institution defaults, the individuals taking part in the joint obligations (and their individual obligations, respectively) should not be automatically considered as defaulted. This mechanism is even more problematic when applied to joint obligations consisting of a large number of individuals in which case considering all the individuals involved in the joint obligation automatically as defaulted may not be economically justified at all. Moreover, the identification of joint fully liability of retail obligors (e.g. married couple) would expose institutions to unbearable burdens especially when this implies ongoing updates of dynamic information (the marital status) difficult to obtain. We believe that para. 85 should be deleted.

Moreover, a global reflection on the materiality thresholds may be considered as it may raise issues of competition between Member States (in some Member States there are presumed significantly past due from the first € 1 by default).

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

In principle yes. As long as the IRB provides enough room for financial institutions to make their own risk assessments, the requirements can be applicable to internal governance.

Since the Basel Committee has already issued guidelines on the credit risk management process applied following the application of IFRS 9, it is essential that there is no contradiction between the two sets of requirements.