

Basel Committee on Banking Supervision
Bank for international Settlements
CH-4002 Basel
Switzerland

14th July 2016

Dear Sirs,

Prudential treatment of problem assets – definitions of non-performing exposures and forbearance

This is the British Bankers' Association's (BBA) response to the consultative document on the above document. We welcome the opportunity to provide our views.

Key points:

In summary, our response makes the following key points:

- The BBA strongly supports the proposal to develop guidelines for the definition of non-performing exposures and forbearance and broadly agrees with the definitions proposed;
- The absence of a consistent international definition for these terms poses significant operational and logistical challenges for banks which operate in multiple jurisdictions. Furthermore, the heterogeneity of definitions imposed by supervisors for regulatory reporting purposes limits the extent to which this information can be leveraged for external disclosure and management information;
- As such, the BBA considers that consistent definitions would not only enhance international comparability of these important metrics for investors and supervisors (all things being equal), but would also enable banks to rationalise their systems and strengthen the consistency of their internal credit reporting; and
- The proposed definitions permit supervisors to tailor the guidelines in a number of important areas, such as the length of the cure period for non-performing exposures. Variability in such important factors will greatly reduce the benefits of an otherwise consistent definition. If this flexibility is to be maintained, then we recommend the development of overarching principles to promote alignment.

Our response below identifies specific comments related to the proposed guidelines.

Main harmonisation features of the definitions of non-performing exposures and forbearance

The BBA broadly supports the proposed harmonisation features and the role these are intended to play within the framework.

Forbearance

The proposed harmonisation features in section 2.2 paragraph 20 are closely aligned with the existing operational practice and would therefore facilitate a better alignment of supervisory driven regulatory reporting and internal credit risk management practices.

Definition of non-performing exposures

Identification of non-performing exposures

Paragraph 21(ii) suggests that the definition applies to off-balance sheet items, including commitments. It would be inappropriate to report unconditionally cancellable retail products as non-performing and we therefore recommend a footnote is included to make this clear.

Paragraph 24(iii)(a) could be clarified to ensure consistent interpretation of how the 90 day past due count should be applied in relation to grace periods. For example, is the count intended to include any grace period or to start from the expiry of such a period provided by a bank to permit a customer to find a solution to a problem?

The requirement in paragraph 24(iii) that an exposure be considered non-performing if there is evidence that full repayment of principal and interest is unlikely without realisation of collateral raises a number of issues. In the first instance, it is not clear how far a bank would be expected to go to identify evidence that full repayment was unlikely. We recommend the standard be one of there being reasonable evidence to suggest this fact.

Second, the stipulation that 24(iii) should be assessed 'regardless of the number of days past due' leaves uncertainty as to the treatment of past term interest only mortgages where there is no obvious repayment vehicle in place but the customer continues to make interest repayments. It is noted that the example of past term interest only mortgages provided in the 'Explanation of Terms' suggests such mortgages should not automatically be considered as non-performing unless the counterparty is at risk of not repaying without the forced sale of the collateral.

Thirdly, 24(iii) may result in uncertainty in relation to repo contracts which are structured on the basis of realisation of collateral at the end of the contract. As such, we recommend that 24(iii) be revised so that the requirement applies to the forced realisation of collateral, which is not in the ordinary course of the product's operation or as part of the product's settlement mechanism.

The definition of 'past due' under paragraph 28 relates to any amount due under the contract which is inconsistent with the use of a materiality threshold proposed by paragraph 24(iii)(a). This leads to a technical question as to the treatment of arrears other than those due under the contract, for example ground rent. The definition should also be aligned with regulatory definitions in relation to how technical or operational failures are handled.

Footnote 8 to the definition of 'unlikely full repayment' treats 'postponement' of principal as an indicator. As above, it would be inappropriate to treat certain exposures, such as past term interest only mortgages in this way if the customer continued to make the contractual interest payments.

The proposed definition of likelihood of repayment would be very operationally challenging from a retail perspective, where exposures are assessed at a portfolio level and where repayments are made. Whilst debt service coverage ratios, loan to value ratios, credit scores and other relevant indicators assist retail lending institutions in assessing a borrower's probability of default, they are not in themselves indicators of non-performing status. Indeed, the debt service coverage ratio is assessed at origination and would become irrelevant over the longer-term. Equally, loan to value ratios are not always/often monitored at the level of individual retail clients but rather value is determined at origination and updated by application of regional factors.

The example linked to interest only mortgages could be read as implying that an interest only mortgage should be regarded as non-performing unless there is a repayment vehicle in place. Whilst we would not agree with this as a matter of principle, from a practical standpoint it is not always possible for a bank to identify whether or not a repayment vehicle remains in place. It also appears that there is a word missing from the sentence which reads: 'If a counterparty is at risk of [not] repaying all or part of the principal...'.

Interaction of non-performing exposures with forbearance

The drafting is sufficient to clearly convey the policy intent.

In relation to paragraph 31, it should be noted that for long-term exposures such as mortgages and credit cards, the drivers of current financial difficulties or forbearance may be unconnected to previous instances (driven by different life events) so the existence of previous forbearance or financial difficulties might not be relevant to the current assessment of credit quality.

Reclassification of non-performing exposures as performing

Paragraph 32(ii) suggests that a non-performing exposure can be reclassified as performing if repayments have been made over a continuous period as specified by the supervisor. Given the requirements of paragraphs 32(i) and 33(iii) it is not altogether clear why paragraph 32(ii) is necessary. There is also a risk that supervisory discretion on this crucial point will greatly diminish the benefits of a consistent definition of non-performing exposure. Should different supervisors adopt different cure periods then cross-border banks will be required to apply and track the different definitions and explain the variability in their public reporting.

At a more detailed level we note that 'continuous period' implies that no payments can be missed during the period and so does not allow for payments which are missed due to operational issues. We therefore recommend aligning the exit criteria with financial reporting required by the European Banking Authority (FINREP). Further, retail credit risk systems are typically focused on arrears status and do not necessarily capture payments made. Furthermore, the entry criteria are based on the exposure being more than 90 days past due. We recommend that paragraph 32(i) be clarified so that the requirement is for the exposure to be less than 90 days past due (rather than all exposures to the debtor).

We recommend a cross-reference between paragraphs 33(iii) and 43(ii), which both relate to the granting of forbearance to exposures already regarded as being non-performing.

The practicality of the requirements under paragraph 34, which require banks to provide information on the amount of non-performing exposures both gross and net of value adjustments and provisions, is uncertain. For example, it is not practical to allocate collective provisions in this way. It is not clear how the proposal should include assets held available for sale (AFS) where changes in value are recognised only when permanent diminution in value are recognised through release of reserves.

Definition of forbearance

The BBA broadly supports the proposed definition of forbearance, and welcomes the fact that this is built on the basis of the counterparty's financial difficulty and the granting of a concession the bank would not otherwise consider.

Identification of forbearance

The non-exhaustive list of examples of indicators for identifying financial difficulty is welcome. Example (b) under paragraph 40 introduces significant judgement to the definition which may run counter to the ambition of achieving a consistent definition. In operationalising the guidelines, banks will need to make operational decisions as to how they interpret when it is 'probable' that the counterparty will be past due and what should be regarded as the 'foreseeable' future over which this assessment should be made. Furthermore, the difference between what is done to assess whether a customer meets the criteria in para 40(b) (not past due, but probable that will be past due in the foreseeable future) and those in paragraph 28 (unlikely full repayment) is not clear. If the assessments are essentially the same then it can be considered that non-performing exposures are already captured under 40(f) and that 40 (b) can therefore be considered superfluous.

We have the following additional comments in relation to the proposed examples under the definition of 'concession':

- We recommend that (f) provides specific flexibility for banks to enter into short-term payment arrangements with clients without triggering forbearance, particularly where arrears continue to accrue at the original rate. Given that the definition of 'Concession' on page 13 refers to 'special contractual terms' which give 'considerably more favourable terms', this would appear to be consistent with the intention of the principles. We note that the US definition of Troubled Debt Restructuring makes clear that such short-term changes to the payment profile should not be regarded as forbearance and recommend a similar approach here. Furthermore, a change in a customer's circumstances, such as a change of job, which leads to a request to change their mortgage payment date because due to a different salary payment date should not be regarded as forbearance;
- The reference in (h) to releasing collateral differs to the other examples which otherwise all relate to the contractual cash flows. Non-payment concessions of this type are challenging for banks to monitor and collect and we therefore recommend the examples relate just to cash flows and that (h) be deleted. This would moreover improve alignment with the principles of a distressed restructuring default in, e.g. the Capital Requirements Regulation (CRR), which recognises only concessions that relate to contractual cashflows. It also does not recognise that collateral releases in instances of significant over-collateralisation are of such character as to not represent a concession, particularly if the release is to allow orderly disposal by the customer with the firm's consent;
- The reference to deferring recovery or collection activity for an 'extended' period of time is unclear (j). The judgement is likely to differ depending on whether or not the exposure is secured or unsecured. Furthermore, there may be situations such as student debt where deferring collections activity may maximise recovery and therefore it would not be sensible to treat as a concession; and
- In addition to the above, we would not regard deferring collection action as equating to forbearance (j) in all instances. Indeed, many banks follow voluntary codes which commit them to minimum standards when taking enforcement action against, particularly, retail clients. Furthermore, some jurisdictions have adopted mandatory requirements of this type.

In terms of the reference to refinancing an existing exposure with a new contract due to the financial difficulty of the counterparty, we recommend that the test of whether or not this should be regarded as forbearance should lie in whether or not the new exposure is on commercial terms.

The final bullet relates to the exercise of clauses embedded in the contract and that these should be regarded as forbearance if the counterparty is in financial difficulty. We disagree with this on both the practical grounds that it is not always possible to test for financial difficulty and the fact that, even if the counterparty is in financial difficulty, the exercising of contractual rights cannot reasonably be regarded as forbearance in that no concession is being granted to the customer. The variation in contractual cashflows is part of the contract and it is not concessionary in the ordinary language use of this term.

Criteria for exit from the forborne exposures category

We broadly agree with the proposed exit criteria and that both should be met before an exposure can be considered no longer forborne. It is not clear, however, how the second criterion (paragraph 41(ii)), will be assessed. For a retail client, the status of the payment history and whether or not this is up-to-date would be taken as an indicator that the counterparty has solved its financial difficulties. As such, we recommend that this factor not apply for retail exposures. It would also be helpful if this paragraph was clear that by "solving" financial difficulties it is meant that the counterparty is regarded as able to meet the contractual payments due under the modified terms and conditions, rather than referring to the original terms which are no longer contractually relevant.

In terms of the specifics, it will be very challenging for banks to monitor multiple probationary periods and we therefore recommend that the guidelines indicate that supervisors should aim to set only a single uniform period rather than amending reporting requirements to impose this one year definition (paragraph 41(i)). A one year definition is generally to be preferred to longer periods. The simplicity of the test is also greatly welcomed. Lastly, the probation period should relate to contractual payments due and not necessarily both principal and interest.

BBA contact:

Adam Cull
adam.cull@bba.org.uk
+44(0)20 7216 8867