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EBF response to Basel Committee Consultative Document: Guidelines: Prudential treatment of problem assets - definitions of non-performing exposures and forbearance

KEY MESSAGES

- The EBF supports the harmonisation of the definition of non-performing exposures and forbearance to ensure consistency in its application, transparency, and comparability of risk parameters among banks and to improve banking supervision at global level.
- The European banking sector has undertaken significant investments on internal processes and IT infrastructure in order to comply with the recently implemented new definitions of non-performing exposures and forbearance as required by the European Banking Authority (EBA). The EBF therefore advocates for consistency of the Basel Guidelines and the EU rules and for a level playing field at global level.
- Finally, while in general the EBF supports the objective to promote consistency between reporting and supervisory frameworks, it is important to acknowledge that the new definitions introduced by the BCBS are not mandatory for the use in accounting concepts.

GENERAL COMMENTS

We welcome the aim of the Basel Committee to harmonise definitions of non-performing exposures and forbearance to ensure consistency in its application, transparency, and comparability of risk parameters among banks. Achieving international consistency is important not only because it will likely result in reducing the reporting burden of internationally active banks but also to improve banking supervision at global level. Global definitions allow for making comparisons across international banks and increase common understanding that banking supervisors may achieve.

It is however important that the regulators strike the right balance between the benefits from increased harmonisation and comparability on the one hand, and the costs of implementation that banks would face – allowing sufficient time for implementation – on the other hand.

The European banking sector has undertaken significant investments on internal processes and IT infrastructure in order to comply with the recently implemented new definitions of non performing and forbearance as per EBA requirements (EBA Final Standards on Supervisory reporting on forbearance and non-performing exposures under Article 99(4) of Regulation (EU) No 575/2013 – July 2014, hereby the “EBA ITS”). We therefore welcome the fact that, to a large extent, the draft Guidelines are consistent with the existing EU Regulation. However, we note a few incoherent features and differences between the EBA

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rules and the BCBS proposed guidelines that would require further changes and adaptation in processes and IT infrastructures already implemented by banks.

In order to strike a balance between the benefits from increased harmonisation and the costs of implementation, we would suggest BCBS to consider the points of differences between the proposed guidelines and the rules already enforced at EU level, to see whether such differences could be eliminated by proposing global guidelines that are not in conflict with the EU rules.

Finally, while in general the EBF supports the objective to promote consistency between reporting and supervisory frameworks, it is important to acknowledge that the new definitions introduced by the BCBS are not mandatory for the use in accounting concepts.

SPECIFIC COMMENTS

Accounting implications

To avoid any doubts, we believe the Guidelines should clearly state that the IFRS 9 stage 2 should not be considered as indication of default.

Also, the classification of an exposure as forborne should not be automatically considered to be a driver for classification of exposure to stage 2 under IFRS 9. Under the IFRS 9, the criterion for classification of the exposure to stage 2 will be the "significance of the credit risk increase". For this reason, while most forborne exposures are expected to be classified in stage 2, there could be some justified exceptions.

Given the existence of the probation period under the prudential framework and the symmetrical approach of IFRS 9, there will be stage 1 exposures that are still classified as forborne in prudential terms but no longer are considered as significantly riskier since origination.

Probation period (Paragraphs 32 ii and 41 (i))

To ensure a level playing field, we suggest to define a common probation period applied homogeneously in every jurisdiction. This is increasingly important given that major rating agencies have begun to consider the non-performing loan ratio in their rating methodologies.

Banks that are to comply with shorter time periods prior to re-classification as performing, would show lower non-performing loan ratios and be better assessed by rating agencies, assuming all other parameters are equal.

The European banking authority is requiring that forborne non-performing exposures could be reclassified as performing forborne exposures only after at least one year has passed since the forbearance measures were taken or since the forborne exposure becomes non-performing (whatever comes later).

Also, at least two years have to pass from when a forborne exposure started to be considered performing before an exposure could be considered as not forborne.

We consider it important that probation periods are harmonised at global level and that European banks are not put in any competitive disadvantage.

Concerning paragraph 32, it is noted that based on the latest consultation paper by EBA, a minimum 3-month period for the return to non-default status is being proposed (subject to finalisation). This period will in turn be applied to the non performing exposures, as a defaulted exposure is always treated as non-performing. Additionally, a minimum of 1-year probation is applied to Forborne Non-Performing Exposures. Finally, for an exposure to be reclassified to performing, the counterparty must not be impaired, must not be defaulted and must not be assessed as unlikely to pay its obligations without realisation of collateral.

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In line with the above, we believe that the exit criteria are already extensive, will be further extended through EBA default definition, and already capture the essence of point 32 (ii). (i.e. any postponement of capital & interest payments is being practically taken into account through the above mentioned criteria so that the 12-month probation period is being effectively extended as long as all of these criteria are not met).

Moreover, a clear indication of the starting period of the probation period in paragraph 41 (i) for the exit criteria from the forborne exposures category is necessary. The BCBS reports that "*The starting date of the probation period should be the scheduled start of principal or interest payments under the revised terms*". The EBA requires that the forbearance classification shall be discontinued when a minimum 2 year probation period has passed from the date the forborne exposure was considered as forborne performing. In addition, we would suggest that the start date of the probation for a forbearance to be aligned with EBA and thus be the date when the forbearance measures are applied.

Materiality threshold

A common rule on the usage of absolute and/or relative thresholds for retail/non-retail segments should be clearly quantified with the type of calculation prescribed (at facility level or at counterparty level) to ensure a level playing field.

In relation with the materiality threshold issue, we suggest to introduce clear guidance on the exclusion of "technical defaults" which should not only cover the errors in data or IT systems but also all the exposures below the materiality threshold indicated.

Pulling effect (Paragraph 19)

We believe a threshold at the level of 20% should be introduced. Only when an institution has on its balance sheet exposures to a debtor that are past due by more than 90 days the gross carrying amount of which represents more than 20 % of the gross carrying amount of all on-balance sheet exposures to that debtor, should all on-and off-balance sheet exposures to that debtor be considered as non-performing.

Paragraph 31

The BCBS's wording, especially in paragraph 31 leaves room for a subjective analysis, which could lead to non-harmonised categorisations. In order to achieve harmonisation, the EBA has mandated for direct reclassification as non-performing all the forborne performing exposures which before were classified as non-performing and during the probation period call for further forbearance measures and/or shows unlikeliness to pay (forborne contract is more than 30 DPD).

Paragraph 33

With regard to point (i), we suggest that the exposures with a partial write off/write down should be eligible for classification as performing, provided that the relevant exit criteria are covered (non-defaulted, non-impaired, minimum probation period, etc).

Paragraphs 34 and 35

IFRS 9 already requires that interest income be recognised on a credit-adjusted basis. We would suggest removing the reporting requirement in paragraph 35 related to the amount of interest income recognised on non-performing exposures. We question the meaningfulness of the reporting of interest income on non-performing loans given the differences between accounting and regulatory requirements and the divergence in practice.

The practicality of the requirements under paragraph 34 requiring banks to provide information on the amount of non-performing exposures both gross and net of value adjustments and provisions is questionable.

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Paragraph 38

The following differences could bring about slightly different interpretations and, consequently, to a different evaluation in the implementation process.

BCBS CP: *"Forbearance includes concessions extended to any exposure in the form of a loan, a debt security or an off-balance sheet item (e.g. loan commitments or financial guarantees) due to financial difficulties of the counterparty".*

EBA ITS: *"All off-balance-sheet items (financial guarantees given, loan commitments given and other commitments) are covered by the definition of non-performing exposures, and some off-balance sheet commitments are also covered by the forbearance definition"* (page 3). It seems that EBA does not consider the financial guarantees in the forbore perimeter and this is also confirmed by the standard FinRep templates 18 (Information on performing and non-performing exposures) and 19 (Information on forbore exposures).

We would recommend the alignment with EBA's ITS.

Paragraph 40

We propose to delete from the concession definition the reference of financial difficulty due to its previous consideration in paragraph 37 as an additional requirement to the concession, in order to consider an exposure as forbore. Therefore, the examples of concession shown on page 13 of the document referred to can be associated or not to financial difficulties.

In relation with the embedded clauses, the BCBS CP does not require further approval of the bank to exercise the clauses, since the financial difficulty assessment is considered sufficient: *"... should be treated as concessions if the bank assesses that the counterparty is in financial difficulty"*.

The EBA ITS instead requires the approval of the bank: *"The exercise of clauses which, when enforced at the discretion of the debtor, enable the latter to change the terms of the contract ("embedded forbearance clauses"), shall be treated as a concession when the institution approves the exercise of the clauses and assesses that the debtor is in financial difficulties"*.

We would propose to align BCBS' requirements with the ones of EBA ITS.

Clarification is needed in the following areas:

- *It is unclear whether a concession within a period of 2-3 months would be considered as belonging to the same incident or as "double forbearance".*
- *What would be an example of "refinancing an existing exposure with a new contract due to the financial difficulties of a counterparty could qualify as a concession even though the new contract has no more favourable terms for the counterparty than the existing transaction"? Is ease of covenants supposed to be considered a concession? Are clauses which can suspend the repayment of the loan such as moratoria, standstill periods, etc., granted with the aim of renegotiating the terms of the debt, to be considered as forbearance measures?*
- *Clarification and further guidance would be appreciated on paragraph 40 (j) – differing recovery.*

Paragraph 41

The BCBS does not specify the minimum amount required for forborne performing exposures. We would suggest the alignment with EBA ITS: *"The classification as forborne shall be discontinued when all of the following conditions are met: ...(c) regular payments of more than an insignificant amount of principal or interest have been made during at least half of the probation period..."*.

Paragraph 28

The footnote 8 considers postponement of principal as an indicator for unlikeliness to pay. We would appreciate clarification as to the application of this criteria to "interest only mortgages" when the customer continues to pay the contractual interest payments. 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 it, we would also like to mention that it is not always possible for a bank to identify whether or not a repayment vehicle is in place.

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