



DRAFT REGULATORY TECHNICAL STANDARDS ON MATERIALITY THRESHOLD OF CREDIT OBLIGATION PAST DUE UNDER ARTICLE 178 OF REGULATION (EU) 575/2013

The AEB is grateful for the opportunity to comment on the consultative document on materiality thresholds of past due credit obligations, issued by the EBA on October 31, 2014.

The AEB agrees on the need for standard European materiality thresholds for defining past due exposures as in default, inasmuch as it will facilitate comparisons between institutions at the European level.

In general terms, we share the views expressed by the European Banking Federation (EBF), however, we would like to convey our views on some aspects that are particularly relevant for Spanish banks.

The Spanish banks that we represent agree that option 2, recognition of default after both thresholds (absolute and relative limit) are breached because it really leaves out virtually all cases of technical default, as intended, without representing any material departure from the general principle of computing all true defaults for regulatory modelling purposes. Nevertheless, in addition, we believe that several aspects should be borne in mind in defining the criteria. The most important are:

- The absolute thresholds, as proposed in the draft, present certain limitations, as we explain below. Additionally, we believe that a better approximation could be to define one threshold for each regulatory portfolio (exposure class) and that absolute thresholds should be higher than the ones proposed in the draft.
- We consider necessary to include the expert judgement in the materiality analysis.
- It seems appropriate to allow institutions to hold, in a voluntary base, more restrictive criteria than those held by the RTS.
- Consideration of certain modifications in the definition of default as a non-material change.

More specifically:

1. Establishment of thresholds

The Spanish banks we represent agree that **option 2, recognition of default after both thresholds (absolute and relative limit) are breached because it really leaves out virtually all cases of technical default, as intended.**

In addition, we consider that there are several **objections of a practical nature to the application of absolute thresholds.** The main ones are:

- An absolute threshold could be a reference in a single uniform context of standard of living, consumer costs, etc., but this is not the case for institutions present in different geographical regions, currencies and markets.
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Consequently, it does not seem possible to establish a single absolute threshold for diverse aggregations of geographies, products and customers, with wide differences between the uses of the funds lent.

- It would be necessary to bear in mind the effect of inflation on the absolute threshold over time. For that, a frequency and a procedure would have to be established for the updating of the same and its application in all institutions. On the one hand, this would potentially give rise to step-like changes (cliff effect) at each updating. On the other hand, the measure of inflation to be applied in the updating would have to be decided, with the associated difficulty of bearing in mind portfolios not only in the various European countries, but outside Europe.

The need for recurrent updating would conflict with the aim set out in point (1), page 11 of the Draft RTS, that the threshold *'is expected to remain consistent over time'*, and would give rise to additional expenses for institutions, not only to implement a more parametrizable system of thresholds, but to analyse the periodic impacts of each change of threshold.

- If absolute thresholds are maintained at the proposed levels (€500), they could interfere with the management of wholesale customers, since a non-payment of that amount could be due to commercial reasons (negotiation of a commission, etc.) and not to insolvency.

In this respect, we consider that a better approximation could be to define different, higher, absolute thresholds according to the different regulatory portfolios (exposure class). Similarly, for IRB institutions, different thresholds to those established in the regulation could be proposed to the supervisor if the empirical evidence of the institution's historic data clearly shows that the regulatory threshold introduces significant biases (numerous technical defaults) that distort the estimation of the risk parameters (PD, LGD, CCF).

2. Including the expert judgement in the materiality analysis

To complement the establishment of the threshold, **we consider it necessary** to allow **entities to apply exceptions evaluated by expert judgement** in the **materiality analysis**. This would allow:

- The exclusion of technical breaches, for reasons other than the insolvency of the creditor, that surpass the limits of the threshold defined, such as an operational problem in the institution in the process of being solved.
- The inclusion of breaches within the limits of the threshold for consideration as defaults, if significant financial difficulties in the creditor are observed, even though the amount outstanding may be small.

This expert judgement is positively envisaged in different financial contexts, such as the accounting framework (i.e. **IAS 39**, paragraph 62: *...an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for...*)

The exceptions, logically, should be justified in each case and appropriately documented, at the disposal of the supervisor that may require it.

3. Allowing entities to hold in a voluntary base a more restrictive criteria than those held by the RTS.

- ✓ Paragraph (4), page 11 of the RTS establishes that the thresholds defined for the identification of default constitute a maximum level. According to that principle, we understand that institutions could maintain thresholds with characteristics similar to those determined in the final version of the RTS, but more restrictive.
- ✓ This would allow the costs of the developments required to implement the RTS to be reduced, while maintaining the necessary levels of conservatism and consistency. Otherwise, very significant costs could be incurred for the development of processes, systems, reconstruction of historic data, etc., which would mean undertaking projects with high costs in terms of time and resources, both financial and human.
- ✓ More generally, following the same principle, methodological approximations should be permitted if they can be shown to be more conservative than those established in the RTS. By way of example, institutions should be permitted to apply a more conservative, but at the same time simpler, calculation of the threshold, including in the numerator the total amount of the outstanding payments (when at least one of them has been outstanding for 90 days) instead of only the quotas that have remained unpaid for 90 days. Similarly, institutions should be allowed to apply the new definition of materiality alone as of the implementation date, instead of recalculating the historical data, as long as the changes produced are not significant nor less conservative than those that would result from applying the new materiality framework to the whole history. It should be possible to confirm this by analysing the data for one or two years.

4. Consideration of certain modifications in the definition of default as a non-material change.

Given that the possible modifications in each institution arising from the definition of materiality would be due to an obligatory regulatory change, the AEB considers that they should not be classed as a significant change, as long as they do not have a significant quantitative impact, as defined in the document *"On the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for credit and operational risk in accordance with Articles 143(5) and 312(4)(b) and (c) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)*.

This **consideration of a non-material change**, if it does not have a significant quantitative impact, **would avoid impacts** on the daily **credit risk management and negative impacts** on the timetables for the **development and establishment of new models**, with the consequent savings of resources, for both the institutions and the supervisor.

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 AEB would be in favor of Option 2 (recognition of default after both thresholds are breached), as explained above, and additionally: the amount of the absolute thresholds and the variety of thresholds should be both increased to adjust them to regulatory portfolios; to allow entities to apply exceptions evaluated by expert judgement in the materiality analysis; and the voluntary use by entities of more restrictive criteria should be allowed.

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

The AEB considers that the European Banking Federation proposed figure for the relative threshold is reasonable. Additionally we believe that a better approximation could be to define one threshold for each regulatory portfolio and that absolute thresholds should be higher than the ones proposed in the draft.

Q3. How much time is necessary to implement the threshold set by the competent authority according to this proposed draft RTS? What is the scope of work required to achieve compliance? [B1]

The Spanish Banking Association (AEB) considers that a term of 2 years is reasonable under the conditions indicated in the previous sections, i.e. allowing institutions to use more restrictive criteria and considering that the establishment of the threshold does not constitute a significant change.

Otherwise, the time required would be longer, for the following reasons:

- The changes would imply significant technological developments that take time to implement. Similarly, the time required for the accreditation and validation of the developments mentioned would have to be considered.
- The processes of recalibrating the IRB models of all the portfolios could mean 1 to 2 years of calculations, documentation, reviews (audit and validation) and governance.
- If the impact of the change is considered significant, the recalibration and review of the models would have to be signed off by the competent supervisor. This has also its own timeframe that should be factored into the implementation period. Some jurisdictions may take as much as a year for a supervisory review.

Q4. Do you agree with the assessment of costs and benefits of these proposed draft RTS? [B1]

As indicated with regard to the timetable in the previous answer, the costs will depend on the definitive text of the regulations, and could be very high if the aspects discussed with regard to the possibility of considering more restrictive criteria and not classing the establishment of the threshold as a significant change are not borne in mind.

It may also be reasonable to allow institutions to opt for some implementation expedients, as long as they do not cause a significant deviation from the proposed

materiality threshold or they are proven to be more conservative than the approaches proposed. For example:

- Institutions may choose to include all past due amounts, rather than only those 90 days overdue, in the numerator.
- Apply the new threshold for capital calculations leaving historical estimations calibrated with the entities' previous materiality definitions (i.e. a prospective implementation) provided that the previous materiality definitions are more conservative.

Q5. What is the expected impact of these proposed draft RTS? [B1]

The potential impact depends very much on the final decisions adopted, in line with our answers to Q3 and Q4.