A response to the PRA's consultation on CP17/18

Credit risk: the definition of default

29 October 2018

Introduction

UK Finance is pleased to respond to the PRA's consultation on CP6/18 Consultation Paper on *Credit risk: the definition of default*.

UK Finance represents more than 250 of the leading firms providing finance, banking, markets and payments related services in or from the UK. UK Finance was created by combining most of the activities of the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association. Our members are large and small, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks. Our members' customers are individuals, corporates, charities, clubs, associations and government bodies, served domestically and cross-border. These customers access a wide range of financial and advisory products and services, essential to their day-to-day activities.

The consultation is directly relevant to many of our larger members that already use an Internal Rating Based (IRB) approach to determine credit risk capital, as well as to many of our specialist and challenger bank members who are currently weighing the costs and benefits of seeking approval to migrate to an IRB approach, taking advantage of the PRA's helpful clarification of the process for doing so.
We review below our key observations on CP17/18.

Implementation Date

The extent and complexity of regulatory changes impacting capital requirements, culminating in the BCBS Basel III changes which initially come into effect on 1st January 2022, with a subsequent five-year transition period, will be wide-ranging and resource intensive both for our members and the PRA to implement.

Fundamental redevelopment of ratings systems will be required. The time required to then obtain regulatory approval and implement them, coupled with the delays in finalising requirements such as the EBA RTS on nature, severity and duration of economic downturn, all suggest that a consistent implementation date and phase-in arrangements will help ensure a reasonable and orderly transition to the new standards.

We have significant concerns at the compressed timeframe for implementation changes to IRB models by 31 December 2020. This creates material risks and issues which will be common across the industry. These include:

- High model delivery risk as a result of the reduced timescales from end of consultations to go live and for the finalisation of outstanding regulatory products from both EBA and PRA. Recent feedback from the EBA is that the finalisation of these will move out by two years. It is our strong view that the original window for implementation should not be truncated as a result.

- There are differing, and not wholly clear, dates for implementation elements of the EBA repair programme.
- Go-live for year-end would require model implementation in advance to enable robust testing to be performed on year end reporting – a 1 January 2021 start date would mitigate this risk
- Development is therefore undertaken 'at risk' and there is no window of opportunity to reverse decisions
- It is not yet clear how the PRA review and approval process will work
- Time has been allocated in our members' implementation plans for the PRA to review Retail IRB rating systems: however, this is the absolute maximum time, may not be aligned to the PRA review/approval process and is likely to reduce if model development complexities arise

We expect that there would be fluctuations in capital requirements caused by a series of changes introduced consecutively over a relatively short period, with potential resultant confusion in messages to the bank investors.

It is our firm view that the timeline for implementation of the EBA and PRA IRB changes should be aligned with that of the BCBS Basel III changes, and that transitional relief is applied for all significant capital changes (as has been done in the past and is proposed by the BCBS) and is not limited just to the move from 180 to 90 days past due.

Interaction with EBA GL and when 'months in arears' not being used

The EBA GL states that the main purpose of the RTS on the materiality threshold for past due exposures is to identify situations where small amounts are past due as a result of technical circumstances, rather than because of the financial situation of the obligor, in order to eliminate them from the estimation of risk parameters.

Given the PRA has indicated a zero-materiality threshold for Retail in paragraph 2.1 of the CP, it should be noted that where the 'months in arrears' payment allocation scheme is not used the need to exclude low material past due amounts from default may remain.

'Months in arrears' payment allocation

We welcome the PRA proposal to allow UK firms to continue to use the 'months in arrears' payment allocation scheme, which we consider to provide stronger risk discrimination than the counting of days past due.

The RTS requires the relative component of the materiality threshold to be set at 1% where that reflects a level of risk that the competent authority considers reasonable.

Paragraph 2.10 suggests that the PRA considers the 1% relative threshold for alternative payment allocation scheme may reflect a reasonable level of risk when used with alternative payment allocation schemes. The proposal in Paragraph 2.1 for Retail/non-Retail assets does not include this option.

Clarity would be welcome on:
- whether the PRA intends to set a 1% absolute threshold for alternative payment allocation schemes
- if so, can PRA provide examples of alternative payment allocation schemes where it will be invoked
- Will there be a burden of proof on firms to show evidence supporting approach if not using 0/0 threshold?

If the PRA intends to set a 1% absolute threshold for alternative payment allocation schemes this option should be included as an addition item (iii) in paragraph 2.1 item for consistency and clarity.

Recognition of other jurisdictions' approaches

Retail

For retail exposures, the PRA proposes to set both the relative and absolute materiality thresholds at zero. Our members support this for UK retail portfolios and request confirmation on whether the thresholds also apply to non-UK retail portfolios, both EU and non-EU exposures. Also, the ECB has recently proposed non-zero materiality thresholds for retail exposures (€100 absolute and 1% relative) and so our members request confirmation that the PRA will recognise the ECB's Retail threshold when used to develop Eurozone retail models. Our members feel the use of different thresholds between countries is not inconsistent with the approach to modelling retail portfolios and so mutual recognition for consolidated reporting to the PRA would be justifiable and advantageous.

Non-Retail

For non-retail exposures, the PRA proposes to set non-zero materiality thresholds, of 1% relative and €500 absolute, which is consistent with the thresholds proposed by the ECB. In addition, the PRA proposes to include an expectation in its supervisory statement SS11/13 that a lower materiality threshold may be used for non-retail exposures where a firm considers it to be a more relevant indication of default. Our members support both proposals and agree with the PRA's assessment that non-retail customers are more likely to default for unlikeliness to pay reasons before reaching 90 days past due.

We note that the alignment between the PRA and ECB proposed materiality thresholds supports the application of a consistent definition of default for international wholesale customers which are likely to bank in more than one country. Our members request confirmation from the PRA of whether the proposed thresholds are intended to apply to UK non-retail exposures only, or to all non-retail exposures within a consolidated banking group? The effect of the latter will mean using the thresholds for third country (non-UK and EU) non-retail exposures whereas the ECB thresholds will apply to EU exposures. Following on from this request, our members also request clarification on whether the PRA intends to recognise the approaches of a national regulator which requires banks to use higher materiality thresholds than those proposed by the PRA, for customers within that jurisdiction?

Our members request the PRA includes further guidance in SS11/13 to explain its expectations on when a lower materiality threshold can be applied. The non-retail category includes Corporate SMEs - whose risks are more country specific - and Large Corporates, Financial Institutions and Sovereigns – which are global in nature. A global bank would bank a corporate SME in its country of domicile but bank a large corporate in multiple countries. Guidance is requested on which of the following situations is intended when applying lower materiality thresholds:

- In a given country, lower materiality thresholds are used for the Corporate SME portfolio while the PRA thresholds are used for global Large Corporate customers. This leads to a consistent definition of default within the two portfolios but two definitions at country-level. Whilst preferable for model development purposes this would cause issues with risk management and in particular for customers that migrate from one portfolio to another due to, for instance, organic growth.

- In a given country, lower materiality thresholds are used for both the Corporate SME portfolio and global Large Corporate customers – global Large Corporate customers in the rest of the world use the PRA thresholds. The leads to an inconsistent definition of default in the large corporate portfolio but a single definition at the country-level. This benefits risk management and customers which migrate from one portfolio to another, but to the detriment of having a single definition of default to develop a model for the global large corporate portfolio.

Materiality Thresholds

Clarification of the following points would assist model redevelopment activity:

1. Can a bank have different materiality thresholds within the same rating system? This question is asked in the context of existing rating systems that contain both Retail and non-Retail exposures that currently adopt the same materiality threshold.
2. Can a bank have different materiality thresholds for the same exposure class? This question is relevant where there are two rating systems containing the same exposure class and where the exposures within the two different rating systems are managed on a different basis. By way of example; the bank applies a €0 and 0% materiality threshold for a rating system that rates both retail and corporate SME exposures and also applies a non-zero threshold for all other corporate SME exposures, rated on a different rating system, with the result there would be two differing definitions for corporate SME.
3. Can an obligor, such as an SME, change default status when moving between exposure classes, taking into consideration the different materiality thresholds?
4. How frequently would a Foundation bank need to verify they are not overstating defaults and cures when using a lower materiality threshold for non-Retail exposures (paragraph 2.15)?

Removal of the 180 days past due discretion

Although we welcome the alignment of the timing of the removal of the 180 days past due definition of default with the implementation of wider definition of default changes, there are compelling reasons to support the retention of a 180 days past due definition of default, including:

Customers

- Pillar 1 risk weights are an input to the cost of borrowing for banks' customers. An increase in Pillar 1 capital requirement could lead to an increase in loan costs, impacting customers' businesses.

Alignment with operational policies

- We are committed to actively supporting customers through 'short-term' financial difficulties, with the aim of achieving an appropriate and sustainable solution for both the customer and the bank. The definition of 'short-term' difficulties and the internal firm's collections policies are consistent with the use of a 180 days past due backstop
- The collections process is not entirely driven by days past due criterion and litigation could commence at 90 days past due. However, the majority of owner-occupied repossessions are from customers at 180 days or more past due and the monthly volume of litigation cases prior to 180 days past due only represent a minimal proportion of the total 90-180 days past due population.

Cure rates are extremely high – 90 days past due is not a strong indicator of default

The focus on supporting customers through 'short-term' financial difficulties results in a very high cure rate for customers hitting the 180 days past due backstop, which is further increased under a 90 days past due definition.

Country specific nuances means alignment with the rest of Europe is not appropriate

The UK mortgage market is a well-established, mature market with low levels of through-the-cycle incurred losses and a rich history of data.

There are some key structural differences (e.g. high proportion of ownership) between the UK and many other European mortgage markets. This factor means a consistent definition of default across all EBA jurisdictions is not appropriate.
The interaction of a 90 days past due definition of default with the regulatory LGD floor most heavily impacts low-risk, low loan-to-value lending, which has low modelled and realised LGD. Removal of the national discretion may have the unintended consequence of increasing risk in the financial system, as higher loan-to-value lending becomes relatively more attractive.

Regulatory consistency

The proposal to remove the use of the 180 days past due will cause a misalignment in the definition of default between the UK and US. In the US, under the Advanced Approach the definition of default states that for residential mortgage exposures, the exposure will be considered in default if 180 days past due. The proposal to revert to 90 days past due by the PRA will therefore create an un-level playing field between the two jurisdictions.

Complexity of change

Days past due counting mechanisms are most commonly a part of core banking systems, which are among the most difficult and costly to change. This is particularly so as the new counting method will need to run in parallel to days past due measures used for external financing reporting or for purposes of measuring performance against contracts with customers.

Transitional arrangements

We request further clarity from the PRA on the proposed transitional arrangements for the removal of 180 days past due, including the nature of transitional relief and extent of transitional period.
It should be a general principle that transitional relief is applied for all significant capital changes (not limited to removal of 180 days past due) as has been done in the past and is proposed by the BCBS for the Basel III changes (see comments under Implementation Date). The one tranche of transitional relief should therefore be applied which covers all changes, rather than a series of complex, overlapping transitional reliefs.

Distressed Restructuring

The final EBA guidelines on Definition of Default state “distressed restructuring should be considered to have occurred when forbearance measures have been extended towards a debtor as specified in the ITS on forbearance and non-performing exposures”. More recently, both the Basel Committee and EBA have published draft guidelines on the management of non-performing and forborne exposures. They both list “concessions” which firms shall treat as a sign of forbearance and these will affect internal definitions of default given the connection created by the Definition of Default guidelines.

Some concessions are not well defined, such as the term “easing of covenants” in the BCBS paper, also referred to as “Other alteration of contract conditions/covenants” in the EBA paper. Our members request clarity on the PRA’s interpretation and expectations on the meaning of this term in relation to distressed restructuring and forbearance cases, to enable them to align with regulatory expectations as they adopt the new definition.

Distressed Restructuring - UTP alignment with FINREP Non-Performing Forborne and Changes to SS11/13 Internal Ratings Based

We support the alignment with FINREP non-performing forborne and also IFRS9 Stage 3, but note the following possible inconsistencies, which may result in differing interpretations by firms:

- Paragraph 49 of the EBA Guidelines (EBA/GL/2016/07) on the application of the definition of default states distressed restructuring should be the same as Forbearance as defined in FINREP. The

definition in SS11/13, para 11.5 should therefore be aligned to the FINREP definition. If they are not aligned the result will be lower transparency, increased complexity of application and a missed opportunity to have a single unified definition of 'bad'.

- More widely, we consider that the requirements of SS11/13 should be aligned with FINREP as already used in the UK and which forms the basis of definition of non-performing exposures (NPE) in other proposals e.g. EC Pillar 1 backstop, management, disclosure and reporting (FINREP) of NPE and forborne exposures.

It should be noted this requirement may create practical challenges on first implementation as full data history for NPEs may not be available, initially requiring the use of proxies and/or Margins of Conservatism which will reduce over time as history builds up.

Whilst our members intend to comply with paragraphs 50-52 of GL, the NPV test will not be an automated part of default trigger, rather it will be used to identify the treatments and conditions under which a restructure should be considered default.

We hope these comments will prove helpful as the PRA considers refinements of its draft supervisory statement and of course would be delighted to discuss them in more detail, if appropriate.

Responsible Executive

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