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

Basel Committee Consultative Document on Guidelines: Prudential treatment of problem assets – definitions of non-performing exposures and forbearance

Introduction

The IIF and the industry generally have always supported the principle harmonization of financial definitions and reporting (including the LEI project, and the FSB Data Hub initiative, for example). Members certainly endorse the importance of market understanding of non-performing exposures and forbearance as the industry continues recovery from the crisis, building capital and TLAC resources. Similarly, it is understood that there is a link between developing common understandings of such concepts and harmonization of credit risk modeling, which contributes to maintaining the important benefits of the risk based approach. Harmonization of the concept of "forbearance" is especially significant, given the lack of convergence of usage of that term and related terms.

Therefore, the industry supports the general goal of harmonization and promoting consistency in supervisory and reporting usage. However, there are certain points on which general rules should recognize the need to correspond to valid existing points of practice. Furthermore, members have reservations about the complexity that the proposals would introduce, given that they would not remove existing variations. Multiple, overlapping reports and disclosures for different purposes would compound complexity and cause more potential confusion than allowing recognition of certain well-identified exceptions (see, for example the discussion of the 90-day rule, below).

Finally, the intent of the proposal is not always well understood as to its specifics. The broad conclusion of these comments is that more discussion between the Committee and stakeholders would help to clarify and focus this proposal, and help realize its purposes.

The following comments refer to specified portions of the consultative document.

1. Purpose and use of the common definitions

Paragraph 3: While practices vary, it is not because of the "absence of a consistent international framework" but because different practices have grown up in response to accounting, regulatory, tax, credit-risk management, and business standards. While that point of history is not relevant to the goal of harmonization (which members support), it should be recognized that differences exist for valid reasons and the need for international harmonization has only recently been

recognized. This should be taken into account in evaluating the benefits and costs of developing a "consistent international framework", and the history of this issue argues for a reasonable phase-in period insofar as new reporting or disclosures may be required that necessitate changes of systems or procedures, or coordination with regulatory authorities, where relevant requirements for non-performing exposures and forbearance may or may not already exist. Furthermore, the operational burden if data used to derive PDs, LGDs, CCFs, and accounting do not align with the proposed definition of "non-performing" should be taken into account.

Paragraph 7: Enhanced comparability would no doubt be useful for investors, counterparties, and supervisors operating on an international basis; however, the proposal does not spell out why this would "help supervisors to take appropriate supervisory actions". It would be helpful if the Committee could state the goals of *supervisory* convergence that seem to lie behind this statement in order to better understand the intent and possible benefits of the proposal.

Paragraphs 8 –15 (and Executive Summary paragraph (vii)): Although members share the goal of greater comparability of terminology and convergence of usage and practice, there is concern that it is not clear what the Committee means by *"to complement the existing accounting and regulatory framework".* Clarification of the Committee's intent here is important because "complement" could mean "add in parallel to" or "in addition to", or it could mean simply "provide additional information".

This discussion asserts without really explaining that the proposals would "complement" existing accounting and regulatory concepts related to credit quality. As a result, the interpretation could be that the new proposal would add additional reporting and disclosures of information that would be for most purposes duplicative of existing regulatory and accounting disclosures, and would thus add a new layer of complexity without remedying existing inconsistencies. At the least, this implies that further, probably rather complex, Pillar 3 disclosures would need to be made to explain or reconcile the differences, which, without clear appreciation of the benefits, would add to the information overload that banks and users already face.[1]

This additional complexity may be justifiable, but it is not clear that differences from the definitions used for internal models, especially, will be helpful. The deviation of the proposed standard from both US and international accounting standards runs counter to the general desire of supervisors and the industry as they like to keep regulatory standards as close to accounting standards as possible. This needs further debate and examination as duplication of closely related concepts will be burdensome but not helpful. Ideally, the result would be harmonization and alignment that would avoid overlays of concepts for different purposes and duplications or near-duplications of reporting and disclosures.

On the forbearance side, the need for a widely understood definition of the concept is clearer. "Forbearance" and similar terms have been used with considerable variation across firms, regulators, and jurisdictions, so the fairly straightforward approach proposed is welcome. It is noted that the approach is relatively simple and builds on existing Troubled Debt Restructuring

[1] The "specific benefits" set out in Paragraph 15 raise the same questions: the paragraph illustrates the uses of the proposed definitions, without really explaining why they are beneficial or what results would be derived from them.

and EBA forbearance concepts. Wider international convergence on the definition proposed would be quite helpful.

There is, however, a question as to whether "forbearance" is the best possible term. Forbearance" has specific legal meanings in specific contexts (e.g. student loans in the US) and the new defined term is different, which may lead to confusion. Perhaps a new, neutral term could be found, such as "Troubled Debt Concession" or "Troubled Debt Adjustment" – something that would refer clearly to this guidance and not invite confusion with other legal meanings or traditional usages.

For the avoidance of doubt, it should be made clear that classification of loans as "non-performing" and application of the "forbearance" definition for purposes of this guidance would be independent of accounting decisions to move a loan back and forth among stages 1, 2 and 3 of IFRS 9 or provisioning analysis under the US GAAP Current Expected Credit Loss model (CECL). While the guidance would be a useful point of reference for making those judgments, it has historically been the intent of the Basel Committee not to define accounting standards and banks (and auditors) should understand that the accounting decision-making process, while perhaps similar, would be independent of the analysis set out in this guidance.[2] In many, or probably most, cases, the result would be the same, but the formal independence of the process should be maintained.

2. Main harmonization features of the definitions of non-performing exposures and forbearance

Paragraph 19, scope and Paragraphs 22 and 39: Regulatory banking book. While it is stated that the definition of non-performing will be applied to all credit exposures "from the regulatory banking book", and exclude "trading book" exposures, members would appreciate confirmation that this refers only to exposures carried in the trading book (intent based) and not to other instruments marked to market through P&L or FVO (Fair Value Option) loans.

Scope: including debt securities. Further discussion is required as to whether debt securities should be included. Some members would prefer to omit debt securities, which are risk-managed quite differently from loans, whereas others can see an argument for including them in the proposed concepts, so the comment is to suggest a wider dialogue with banks and users before deciding what would be most useful and least confusing. Furthermore, impact analysis is required to determine whether inclusion of debt securities would materially change existing reported results: if the impact would be substantial, then further consideration needs to be given as to whether the change is justified.

Scope: purchased or originated credit impaired exposures. Although purchased or originated impaired loans are not mentioned explicitly, there is concern about their treatment. As a general matter purchased or originated impaired loans should not be included in the definition of non-performing unless subsequent analysis suggests that such loans have become impaired relative to the value at which they were acquired. In US practice, such "PCI" loans are classified separately

[2] It is understood, per Paragraph 24(ii), that exposures already considered impaired for accounting purposes would be considered non-performing for purposes of the guidance.

for disclosure and the non-performing designation would in some sense be redundant, although some banks may provide "management discussion and analysis" disclosure where such loans are material. For IFRS purposes, any losses from the value at which impaired loans are acquired would have to be accounted for, and it is understood that the EBA will make clear that banks are not required to put such loans into the default classification, but to conduct the usual analysis as to losses after purchase. The proposal is also inconsistent with the treatment of such exposures under the recently published CECL proposal.

Further, it should be made clear that the measurement of unlikeliness to pay should be against the amount a bank stands to lose, not the stated amount of a purchased or originated credit-impaired loan. (For example, if a bank has purchased a loan that is in restructuring at 70 and expects to realize, say 75, the borrower's ability to pay should be measured at 70 and not at 100.)

It is not clear how such exposures should be treated as a general matter, so again, wider dialogue with banks and users would be useful.

Paragraph 19: harmonized recognition criteria. Not all members agree with the uniform 90-day past due criterion for *all* types of exposures.[3] Moving toward harmonization is desirable but disclosure based on the strict rule may misrepresent actual business practices in some cases and, as discussed above, lead to increased complexity in reporting because of the additional explanations that would be required if banks have to keep and disclose different sets of records for different purposes. There may be cases where classification based on criteria other than 90 days may continue to be appropriate to reflect business realities and should be continued, subject to appropriate Pillar 3 disclosure.

US and some other banks often do not use non-performing classifications for credit cards, but go directly to charge-off at a defined point, usually beyond 90 days, e.g. 120 days. This reflects the nature of the credit-card business (including the relatively high pricing for credit-card debt, where loss experience is largely priced in); furthermore, consumer behavior, which is well understood for credit cards, has informed current practice. Thus, the 90 day rule would cause divergence from business practice for both reporting and disclosure.

Similarly, some wholesale loans of US banks. that are more than 90 days past due are still considered performing as a result of careful financial analysis and knowledge of the borrower and its circumstances. This is somewhat similar to the situation described in paragraph 28, where it is acknowledged that a contractual term of an exposure should not automatically result in its categorization as non-performing without analysis of the financial situation or payment behavior of the counterparty. Such situations are disclosed.

In other cases, the longer past-due thresholds recognized by local regulators have objective rationales, reflecting longer payment practices (e.g. central governments and certain public-sector entities). It would clearly not be appropriate to put a government or a large public-sector

[3] We also note that a methodology for counting days past due is not specified. Convergence would be furthered by a uniform methodology (e.g. taking into account partial repayments), although the methodology should be suggested only at first, with ample time for phase-in. As with other aspects of the proposal, the greater consistency with existing requirements, the better.

entity, for example, into the “non-performing” category because of a slow payment (perhaps in accordance with normal practice) by one agency or subdivision. This issue is recognized by the EBA and other authorities.

The existence of allowable, defined exceptions such as this should not undermine the integrity or usefulness of the international standard; imposing a purely external 90-day non-performing rule, on the other hand, would only add complexity and artificiality to disclosures.

The current draft also omits any discussion of treatment for non-performing status of *technical defaults*, which may arise from a number of causes, including IT problems or data errors by either the borrower or the bank, and are recognized by many authorities. Technical defaults not otherwise reflecting on the credit condition of the borrower in terms of the criteria stated should be disregarded, and the final version of this guidance should make that clear.

Paragraph 19: role of collateralization. The exclusion of taking any account of collateralization has the virtue of simplicity; however, it has wide implications and needs more debate and consideration.

Part of the problem is that “collateralization” is not defined. Would it extend to, for example, government guarantees of student loans in the US or of mortgages in Canada? If so, some members argue that it would be overly broad because such loans remain fully collectable and need not be placed in a non-performing category. On the other hand, although such loans continue to be counted as “performing” and keep accruing interest for accounting purposes, some banks provide supplemental disclosure on such loans when over 90 days past due. Some would go further and extend the same rationale to over-collateralized loans, where there is no doubt of full recovery of amounts owed. They consider that the proposed disclosure of such loans as non-performing would run against economic reality.

Further discussion of the purposes and usefulness of disclosure of collateralized or guaranteed loans as “non-performing” is required. There is concern that the proposed guidance would in effect require a change of substantive practice, which would go beyond the ostensible scope of the proposal.

Paragraph 19: level of application: It makes sense to assess each retail facility as to collectability, as the draft provides. There is, however, a potential issue of convergence and comparability in that “retail” and “wholesale” are not defined. Many banks would treat SME borrowers the same as “retail” for this purpose, so further clarity (which ideally would be in line with other aspects of the Basel Accord and Basel guidance) would be helpful.

Treatment of wholesale exposures on an entity basis is accepted by some members, but subject to reservations by others. The latter argue that their business and supervisory practices allow them to decide whether, on the basis of analysis of a borrower and its facilities (especially large corporate borrowers that may have multiple facilities with different terms and legal obligors), it would make more sense to examine non-performing status on a facility basis. Banks should have the option to take a facility-level approach to such borrowers. Again, accurate reflection of risk

management suggests making allowance for such practice. Of course, banks in jurisdictions where entity reporting is required would continue to report on that basis.

If any variation of entity-level reporting is retained, there should be a threshold for the “pulling effect” of defaults that would cause an entity to be classed as non-performing. For example, entity-level reporting would not be required unless, for example, on-balance-sheet non-performing exposures represent at least X% of total on-balance-sheet exposures.

In any case, attention to the issues raised under “harmonized recognition criteria” in these comments regarding public-sector entities in particular would be helpful to making this approach workable.

Effective date: It is not clear from when the proposed new definitions would be effective. In the final guidance, it will be important for the Committee to recognize that implementation of the new definitions will require systems and procedures adjustments by banks that may be substantial depending on the final definition of the guidance; therefore, sufficient implementation time should be provided.

In addition, although the point is not raised explicitly in the current proposal, it should be made clear that the Guidelines are not intended to be applied retrospectively or to require any restatement of any reporting or disclosure.

3. Definition of non-performing exposures

Paragraph 23: off-balance sheet items: The rule on including uncancellable nominal amounts of commitments and guarantees should be qualified to take into account the fact that certain facilities, while in principle uncancellable, may contain Material Adverse Change clauses that would allow the bank to protect itself from loss. The rule should allow for exclusion of such facilities from non-performing assets.

Paragraphs 28 and 40(i): explanation of “material”: The concept of materiality does not appear to be used consistently throughout the document. Rather, it should be stated clearly that all aspects of the proposed guidance are subject to the materiality principle. This is especially important to avoid unnecessary disclosures that add to the volume and “noise” of disclosures, without adding value from the users’ point of view.

As stated above, technical defaults and other non-material items should be excluded from the reporting of non-performing items.

The concept of materiality referred to is that in force in a given jurisdiction. This means that there will be some differences in application; however, such differences are acceptable, given directional consistency of all definitions, and probably inevitable. This is an example of why some variations need to be accepted within the broad goal of overall consistency.

Paragraph 28: unlikely full repayment: This discussion (including footnote 8) seems to have been written mainly for wholesale exposures and would be difficult to apply, if taken literally, to many retail exposures.

Paragraph 28: explanation of "financial analysis": The discussion of "financial analysis" (and some aspects of the discussion of unlikelihood of full repayment) seems out of place, unless intended to be purely illustrative, in which case that intent should be made much clearer.

Obviously financial analysis is a very complex topic that cannot be defined adequately in a few paragraphs. If the language is intended to be mandatory (i.e., something against which banks would be examined), then a much more developed and nuanced treatment would be required. Furthermore, a guidance document aimed only at explication of two terms is not the place to define such an important supervisory and risk-management concept and, if it is the Committee's intent to mandate certain aspects of financial analysis, then a separate consultation is clearly in order.

More specifically, the paragraph, including the second bullet regarding retail indicators, would, if retained, need to be revisited to make clear that it is not intended to modify present practice, but that banks can rely on established risk-management practices for retail borrowers. Similarly, it should be made clear that recognized products such as interest-only mortgages would not be captured, absent other indicia of probable default, even if specific arrangements have not been made to assure repayment.

Paragraph 32: when an exposure ceases to be non-performing. Clause 32(ii), "repayments have been made over a continuous repayment period specified by the supervisor" seems unnecessary, especially given 32(i) and (iii). Paragraph 32(ii) adds little to the rest of Paragraph 32, but would introduce a new source of variation and inconsistency because of the supervisory option, for little obvious substantive benefit.

4. Definition of forbearance

See the comments on paragraphs 8-15 above.

Generally speaking, the definition provides a clear and useful definition of "financial difficulty", which has been lacking in other standards.

Consideration should be given to making clear that debt securities would be excluded. Banks generally do not have the ability to renegotiate terms of debt securities in the same way they can negotiate changes or waivers of terms on other debt. Market-based restructurings of debt securities are already disclosed and do not seem to be subject to the same disclosure issues.

Paragraph 40: financial difficulty: clause (g): The fact that a client cannot obtain funds from other sources than its existing banks should not automatically be considered indicative of forbearance. In any crisis period, it is likely that banks may not grant loans to new clients very readily, for a variety of reasons that would not necessarily reflect upon the client's creditworthiness. Therefore, clause (g) should be omitted or qualified so that it does not lead to

procyclical reporting of forbearance when not actually justified by the client's own credit condition.

Paragraph 40: concession; clause (h): The other clauses of the "concession" discussion all share an important underlying feature in that they relate to modifications or accommodations made in relation to the original contractual cash flows. Clause (h) does not relate to cash flows and therefore does not align well with current concepts of default based on cash-flow issues, such as distressed restructuring or troubled debt restructurings. Further, clause (h) does not deal with release of over-collateralization, which may not be concessionary in market terms. Although the introduction to the "concession" section refers to the terms and conditions on which a bank would extend credit in normal market circumstances, the lack of specificity on this point could raise issues, especially if the list of possible forms of concession is interpreted overly prescriptively. Some members believe that "concessions" should be defined as a matter of principle and current practice only to relate to modification of contractual cash flows, and thus that clause (h) should be omitted. Once again, this is a point on which more stakeholder discussion is required to arrive at the most appropriate definition.

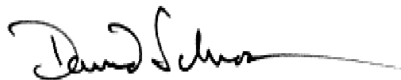
Paragraph 41(i): probation period. It is stated that the repayment period required for reclassification of an exposure as performing would be "at least" one year, provided that other criteria for reclassification are met; however, in order to drive toward true consistency of the definition of forbearance, some members believe a uniform one-year probation period would be appropriate. Again, more discussion is needed before finalization, given the distribution of practice on this point. Clear guidance as to when to start forbearance periods would also be helpful.

Paragraph 41(ii) states that it is required that the counterparty have "solved" its financial difficulties. This is anomalous terminology that may lead to unnecessary interpretative difficulties. It would be clearer to state that the counterparty should be determined no longer to face financial difficulty, as defined, in relation to its then-current contractual obligations.

Conclusion

The Institute hopes that these comments will contribute to appropriate revision of the proposal, the better to achieve its purposes. The Institute and its members stand ready to participate in any further stakeholder consultations that may be organized. Should you have any questions, please contact the undersigned or Hirokazu Masuoka (hmasuoaka@iif.com).

Very truly yours,



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