EBA/CP/2015/15

22 September 2015

Consultation Paper

Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 575/2013

Contents

1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 22.01.2016. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

Article 178 of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR) specifies the definition of default of an obligor that is used for the purpose of IRB Approach according to Chapter 3 of Title II in Part Three of the CRR as well as for the Standardised Approach in line with Article 127 of the CRR. In this regard, Article 178(7) of the CRR mandates the EBA to specify guidelines on the application of this Article. Consequently these guidelines specify all aspects related with the application of default of an obligor.

The EBA has in the past identified differing practices used by the institutions as regards the definition of default. Consequently these guidelines provide detailed clarification on the application of the definition of default, which includes aspects such as the days past due criterion for default identification, indications of unlikeliness to pay, conditions for the return to non-defaulted status, treatment of the definition of default in external data, application of the default definition in a banking group and specific aspects related with retail exposures. The EBA considers this harmonisation to be necessary in order to ensure a consistent use of the definition of default. As a result it will increase comparability of risk estimates and own funds requirements, especially when using IRB models, and will help reduce the burden of compliance for cross-border groups.

It is expected that the implementation of these proposed guidelines might have significant impact on the operations of some institutions. In particular for those institutions that use the IRB approach and where the default definition will change significantly, the implementation of the necessary adjustments may require some time. In order to facilitate the implementation of the changes in default definition, either as a result of these guidelines or any other changes that may be necessary, these guidelines also consider the implementation process and consequently propose only to implement the Guidelines after a phase-in period and provide guidance on this process.

Next steps

The draft guidelines are published for the 4 months consultation period. At the same time the EBA is planning to carry out a QIS in order to assess the impact of the proposed requirements both in quantitative and qualitative manner. The responses received during the consultation period and the results of the QIS will be taken into account when specifying the final guidelines.

3. Background and rationale

The definition of default has been introduced by Directive 2006/48/EC of 14 June 2006 (part of what was known as the Capital Requirements Directive - CRD), later replaced by Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR). The definition of default of an obligor specified in Article 178 of Regulation (EU) 575/2013 includes among others the days past due criterion for default identification, indications of unlikeliness to pay, conditions for the return to non-defaulted status and treatment of the definition of default in external data. However, in the absence of specific rules on these and other aspects of the application of the definition of default various approaches have been adopted across institutions and jurisdictions. As a consequence a wide range of practices has been observed. In order to harmonise the approach the EBA has been mandated in Article 178(7) of Regulation (EU) 575/2013 to specify guidelines on the application of this Article.

In the majority of jurisdictions specific rules have been adopted concerning the counting of days past due and application of the materiality threshold. However, the existence of specific rules on other aspects of the definition of default is much less common. In effect, institutions established their own detailed rules for the identification of default based on their experience and portfolio characteristics. However, substantial variation in these practices has been identified. This is consequently a driver behind the variability of risk estimates and capital requirements and therefore leads to a lack of comparability across institutions.

Definition of default influences own funds requirements both under the IRB and under the Standardised Approach. In the case of the IRB Approach it is the basis for estimation of risk parameters and therefore influences risk weights and expected loss calculation for both defaulted and non-defaulted exposures. In the case of the Standardised Approach the definition of default is the basis for classification of exposures to the class of exposures in default in line with Article 127 of Regulation (EU) 575/2013.

As certain choices in the application of the default definition may have significant impact on the own funds requirements it is important to ensure a level playing field across institutions in the entire EU. Therefore the draft guidelines provide detailed guidance on the application of various aspects of the definition of default, including past due criterion as an indication of default, indications of unlikeliness to pay, specific aspects of the application of the definition of default for retail exposures, application of the default definition in a banking group, treatment of external data and criteria for the return to a non-defaulted status. It is expected that the harmonisation of practices will not only increase comparability of risk parameters and own funds requirements but also reduce the burden for cross-border institutions to comply with different requirements in different Member States.

3.1 Implementation of the changes in default definition

It has been recognised that the implementation of these guidelines might in some cases require significant time and efforts, especially in the case of institutions that use the IRB Approach and where the currently used definition of default is significantly different from the proposed rules. The institutions that use the IRB Approach will have to not only change the default identification processes and possibly IT systems but will also have to recalibrate their rating systems. For that reason it was necessary to allow institutions sufficient time to introduce the required changes. It was also considered appropriate to provide additional guidance on the main aspects of the implementation process.

3.2 Past due criterion in the identification of default

3.2.1 Counting of days past due

In the area of the counting of days past due the harmonisation will be achieved predominantly through these RTS on the materiality threshold for past due exposures. However, the draft guidelines provide clarification of those aspects of counting of days past due that are not covered in these RTS. In particular it has been specified that in the case the credit arrangements allow the client to change the schedule, suspend or postpone the payments under certain conditions and the client acts within the rights granted in the contract, the changed, suspended or postponed instalments should not be considered past due. The counting of days past due should be based on the new schedule once it is specified because in that situation the client is no longer obliged to pay according to the initial conditions. Such rights for clients may be granted by institutions on the basis of specific business strategy or may stem from national regulations related with consumer protection.

Similar considerations apply to the situation where the repayments are suspended by force of law. As the client is legally not obliged to make these payments in the suspension period, the counting of days past due should also be suspended. However, both of the described situations might indicate financial difficulties of the client, therefore institutions should assess this obligor for possible indications of unlikeliness to pay.

3.2.2 Technical defaults

Additionally, the draft guidelines specify the definition and treatment of technical defaults. Although the notion ‘technical default’ has not been specified in the CRR it is commonly used across institutions. Since the understanding and application of this concept varies significantly among institutions it was necessary to provide clarification in this area.

It has to be noted that the main purpose of the RTS on materiality threshold for past due exposures is to identify the situations where small amounts are past due as a result of technical circumstances rather than the financial situation of the obligor and eliminate them from the estimation of risk parameters. Since the materiality threshold already serves the role of identification of technical delays in payments all exposures where the materiality threshold has been breached, all other cases is proposed to be treated as actual defaults. Since the CRR does not envisage any additional exceptions from the days past due criterion the notion of technical defaults is defined as one of the following situations:

- The identification of default results from the error in data or IT systems of the institution, including manual errors of standardised processes but excluding wrong credit decisions;
- The required payment has been made by the obligor before the relevant days past due criterion including the materiality threshold has been breached but default has been identified as a result of long payment allocation process within the institutions.

As in the above situation the criteria for default have not been met in practice, these exposures should not be treated as defaulted. Therefore it has been clarified that when the institution identifies such situation the exposures of this obligor should be removed from the list of defaults and should not be taken into account as defaults in the estimation of risk parameters.

3.2.3 Factoring

Due to specific characteristics of factoring contracts and uncertainty regarding how to apply the past due criterion for these types of contracts, clarification had to be provided in the guidelines. For that purpose a differentiation have been made on two types of factoring arrangements based on whether the risks and benefits related with the ceded receivables are fully transferred to the factor or not. Such a differentiation is necessary as the treatment of exposures in the financial statements of the factor differs and the exposure value for the purpose of own funds requirements calculation is based on the accounting value of exposures.

In effect it is proposed that where the risks and benefits related with the ceded receivables are not fully transferred to the factor and the factor recognises in the balance sheet only the factoring account with the client. Such an account may be treated similarly to an overdraft where a client breaches the advised limit once the account is in debit, i.e. from when the advances paid for the receivables exceed the percentage agreed between the factor and the client. On the other hand, where the risks and benefits related with the ceded receivables are fully transferred to the factor, the factor recognises direct exposures to the debtors of the client. Therefore, such exposures should be treated as purchased receivables and the counting of days past due should commence when the payment for a single receivable becomes due.

3.3 Indications of unlikeliness to pay

3.3.1 Specific credit risk adjustments (SCRA)

The draft guidelines provide clarification regarding the application of each indication of unlikeliness to pay as specified in Article 178(3) of Regulation (EU) 575/2013. In particular it is necessary to provide guidance on how to apply Article 178(3)(b), which specifies that where, as a result of significant perceived decline in credit quality of an obligation, the institution recognizes a SCRA on any exposure of an obligor, this obligor should be classified as defaulted.

In this context it is proposed that all SCRA as specified in Article 1(5)(a) and (b) of the RTS on the specification of the calculation of the specific and general credit risk adjustments, i.e.:

(a) losses recognised in the profit or loss account for instruments measured at fair value that represent credit risk impairment under the applicable accounting framework, and

(b) losses as a result of current or past events affecting a significant individual exposure or exposures that are not individually significant which are individually or collectively assessed,

should be considered to be a result of a significant perceived decline in credit quality of an obligation and hence should be treated as an indication of unlikeliness to pay.

The SCRA related with incurred but not reported losses (IBNR) as specified in Article 1(5)(c) of these RTS should not be considered an indication of unlikeliness to pay. These SCRA cover the losses for which historical experience, adjusted on the basis of current observable data, and indicates that the loss has occurred but the institution is not yet aware on which individual exposure it has suffered these losses. Since such SCRA are not related with the decline in credit quality of any specific exposure they should not be considered an indication of unlikeliness to pay of a specific obligor.

It is expected that by the time of implementation of these guidelines many institutions will already apply IRFS 9 instead of current accounting standards. Since these new rules are significantly different than the currently used IAS 39 and introduce the concept of expected credit losses that is new in the accounting framework, the EBA considers it necessary to specify the treatment of provisions under IFRS 9 – despite those rules not having entered into effect. It is consequently proposed that as a general rule all exposures classified as ‘Stage 3’, i.e. exposures treated as credit-impaired under IFRS 9, should be treated as defaulted. The only exceptions from that rule would apply to those exposures where 180 days past due are used instead of 90 days on the basis of the discretion provided in Article 178(1)(b) of Regulation (EU) 575/2013 and where the materiality threshold in accordance with Article 178(2)(d) of Regulation (EU) 575/2013 is not used for the purpose of classification of exposures to ‘Stage 3’. If in that case 90 days past due are used for the accounting purposes and the credit-impaired status would be the only indication of default such exposure may remain in non-defaulted status. These exemptions are necessary in order to make sure that the treatment of SCRA under IFRS 9 will not overrule the requirements and discretions specified in the CRR, which will supersede the accounting framework.

3.3.2 Sale of credit obligations

According to Article 178(3)(c) of Regulation (EU) 575/2013 a material credit-related economic loss related with the sale of credit obligations should be treated as an indication of default. However, the sale of credit obligations at a loss may result from non-credit risk related reasons such as the need to increase liquidity of the institution or change in business strategy. Therefore it is proposed that for the purpose of identification of default the reasons for the sale of exposures and of any losses recognised thereby have to be taken into account. If the loss on the sale of credit obligations is not related with credit risk and the institution does not perceive the credit quality of those obligations as declined, the sale should not be considered an indication of default even if the non-credit risk related loss is material.

Where however the institution sells the credit obligations due to the decrease in their quality or the loss on that sale is otherwise related with the credit quality of the obligations, the materiality of this credit-related economic loss should be assessed. It is proposed that the loss should be calculated on the basis of the difference between the outstanding amounts of the obligations and the agreed price. If the economic loss is higher than a certain threshold the sale of exposure should be considered an event of default.

The draft guidelines assume that the threshold should be set by institutions in order to allow alignment with internal risk management practices and the assessment of risk by the institution. However it is also necessary to ensure harmonisation therefore the possible range of thresholds is limited by the cap.

3.3.3 Distressed restructuring

According to Article 178(3)(d) of Regulation (EU) 575/2013 a distressed restructuring is an indication of unlikeliness to pay where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement of principal, interest or, where relevant fees. In order to keep consistency with the supervisory reporting framework it has been specified that 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. Therefore those forborne exposures, where the forbearance measures are likely to result in a diminished financial obligation should be classified as defaulted.

It is proposed that the assessment of whether the financial obligation has diminished should be based on the comparison between the present value of expected cash flows before the changes in terms and conditions of the contract and present value of the expected cash flows based on the new arrangement, both discounted using the original effective interest rate. The original effective interest rate is proposed in order to align these calculations with the so called ‘impairment test’ required under the international accounting framework. If the difference between the net present values of cash flows before and after restructuring arrangements exceeds a certain threshold the exposure should be classified as defaulted.

Also in this case it is assumed that the threshold should be set by institutions. However, it does not refer to materiality but should only capture those situations where the change in NPV of the contract results from technical discounting aspects and rounding of the amounts. Therefore the cap threshold specified in the guidelines is lower than in the case of the sale of exposures.

Furthermore, where the difference as described in the previous paragraphs is below the specified threshold, institutions should still assess such exposures for possible indications of unlikeliness to pay. The general principles for the identification of default apply also for distressed restructuring. Therefore, where the institution has reasonable doubts with regard to the likeliness of repayment of the obligation according to the new arrangement in full in a timely manner, the obligor should be considered defaulted. The indicators that may suggest that this is the case include large balloon payment or significantly higher repayment burden envisaged at the end of the repayment schedule.

3.3.4 Bankruptcy

Although the bankruptcy is usually clearly specified in the national legal frameworks it is not that clear how to understand the “similar order” or “similar protection” as referred to in points (e) and (f) of Article 178(3) of Regulation (EU) No 575/2013. Therefore typical characteristics of such concepts have been specified in the guidelines in order to allow harmonised application of this concept for the purpose of default identification.

3.3.5 Additional indications of unlikeliness to pay

As Article 178(3) of Regulation (EU) No 575/2013 does not provide a comprehensive list of all situations that may indicate unlikeliness to pay of an obligor, institutions should specify those other indications of unlikeliness to pay in their internal procedures on the basis of their experience. These indications may reflect specific characteristics of different types of exposures and obligors. One of the aspects that should be considered is the relation between various entities within the groups of connected clients. According to Article 172(1)(d) of Regulation (EU) No 575/2013 institutions are required to have appropriate policies regarding the treatment of individual obligor clients and the groups of connected clients. These policies should in particular specify how the relations between legal entities are treated in the default identification process. It was not possible to specify unified rules in that regard as the appropriate treatment may depend on the legal environment in a specific jurisdiction, business strategy of the institution as well as the design of the rating system used for a specific type of exposures.

3.4 Application of the definition of default in external data

The draft guidelines provide clarification that the requirements with regard to external data apply only to institutions that use the IRB approach and use such data for the purpose of estimation of risk parameters. In these situations it is important to ensure that the sample used for the purpose of the estimation of risk parameters is homogenous and representative for the institution’s portfolio, including in terms of the definition of default that was applied. For this reason institutions should assess the differences between the definitions of default used internally and in external data and their impact on the default rate.

In any case institutions should be able to demonstrate that broad equivalence with the internal definition of default has been achieved in line with Article 178(4) of Regulation (EU) 575/2013. Nevertheless, it is expected that in some cases institutions will not be able to make all necessary adjustments or demonstrate that certain differences are negligible in terms of the impact on all risk parameters and own funds requirements. Therefore it has been clarified that in this situation requirements of Article 179(1)(f) of Regulation (EU) 575/2013 should apply and institutions should include additional margin of conservatism in the estimation of risk parameters.

3.5 Criteria for the return to a non-defaulted status

According to Article 178(1)(a) of Regulation (EU) 575/2013 an obligor has to be considered defaulted as long as the institution considers it unlikely that the obligation will be paid in full without recourse to actions such as realising collateral. Such an assessment should be performed in particular before reclassification of defaulted exposures back to non-defaulted status. In order to ensure that sufficient information exists to perform such assessment and that it is done in a prudent manner minimum probation periods have been specified in the draft guidelines. Only after the analysis of the behaviour of the obligor and its financial situation during the probation period it is possible to assess whether the improvement of the credit quality is factual and permanent. As a result institutions may also avoid excessive number of multiple defaults.

The probation period should not be shorter than 3 months from the moment that the obligor was no longer past due more than 90 days on any material credit obligation and none of the indications of unlikeliness to pay specified in Article 178(3) of Regulation (EU) 575/2013 still apply. If after the probation period institution still assesses that the obligation is unlikely to be paid in full without recourse to realising collateral, the exposures should continue to be classified as defaulted.

Furthermore, loans under distressed restructuring are considered to require particular attention in the reclassification to non-defaulted status because the assessment of days past due is based on the modified payment arrangement and the exposure cannot stop being restructured by the time it is fully repaid. Therefore it has been specified that a longer probation period and additional conditions should apply before such exposures can be reclassified to non-defaulted status. It is proposed that the probation period should be defined as at least 1 year from the latter of: i) the moment of extending the restructuring measures, ii) the moment when the exposure has been classified as defaulted or iii) the end of grace period included in the restructuring arrangements. Additionally, this period should not be shorter than the period during which material payment has been made by the obligor. This material payment may be defined in accordance with the ITS on non performing exposures and forbearance as '*a total equal to the amount that was previously past-due (if there were past-due amounts) or that has been written-off (if there were no past-due amounts) under the forbearance measures'.* This option has the further advantage of ensuring the alignment with the supervisory reporting framework.

In order to ensure that the policies and processes regarding the reclassification of exposures to non-defaulted status are effective institutions should monitor the scale of multiple defaults. It is expected that the institution would have a limited share of obligors who default soon after returning to a non-defaulted status. The analysis of the changes in the status of the obligors or facilities should in particular be taken into account for the purpose of specifying the relevant probation periods.

3.6 Consistency of the application of the definition of default

In order to allow the integration of the definition of default with internal risk management practices it has also been clarified that in some situations institutions may use different definitions of default for certain types of exposures, including in different legal entities or geographical locations. The differences however have to be justified, consistent with the internal risk management practices and may stem in particular from:

- different materiality thresholds set by competent authorities in their jurisdictions;
- use of 180 days instead of 90 days past due for certain types of exposures in some jurisdictions;
- specification of additional indications of unlikeliness to pay specific for certain types of exposures.

Nevertheless, default of an obligor should also be identified consistently across the institution with regard to all exposures of this obligor in all relevant IT systems in all legal entities within the group and geographical locations.

However, it has also been recognised that in some cases such consistent default identification might not be fully possible if consumer protection, bank secrecy or other legislation prohibits the exchange of client data within a banking group. Additionally, consistent identification of default of an obligor might be limited in case it is too burdensome for institutions to verify the status of a client in all legal entities and geographical locations within the group. In that case institutions may not perform the check for consistency on condition that they are able to demonstrate that the effect of non-compliance is immaterial and provide evidence that there are no or very limited number of common clients between relevant entities within a group.

3.7 Application of the definition of default for retail exposures

3.7.1 Level of application of the definition of default

According to Article 178(1) of Regulation (EU) 575/2013 the definition of default may be applied at the level of individual credit facility only in the case of retail exposures. As retail exposures are defined differently for the IRB and the Standardised Approach it is necessary to clarify the possible scope of application of the default definition at the facility level. The proposed clarification provides that institutions that use the IRB Approach may apply the definition of default at the level of individual facility for retail exposures as defined in Article 147(5) of Regulation (EU) 575/2013. Additionally, the individual facility level may be applied for purchased corporate receivables treated as retail in accordance with Article 153(6) of Regulation (EU) 575/2013. Institutions that use the Standardised Approach may apply the definition of default at the level of individual facility for all exposures that meet the criteria specified in Article 123 of Regulation (EU) 575/2013 even if some of those exposures are assigned to different exposure classes for the purpose of assignment of risk weight. This approach will allow consistent treatment of an obligor for the purpose of default identification even if various types of products are extended to this obligor.

The level of application of the default definition for retail exposures should be based on internal risk management practices of the institution. However, if an institution decided to use different levels of application of the definition of default for the different types of retail exposures, the requirements of the CRR for default of an obligor might not be fully met. In particular, where the definition of default is used at the obligor level default of any exposure of an obligor should result in default of all other exposures of this obligor. Where however some exposures of such obligor are assessed at the facility level, default on one of these exposures would not result in default of the whole obligor. In order to avoid such situation it is proposed that where institutions decide to use different levels of application of the definition of default for the different types of retail exposures they should provide evidence that there are no or very limited number of situations where the same clients are subject to different definitions of default at different levels of application.

3.7.2 Pulling effect

In the case of institutions that decide to apply the definition of default at the level of an individual credit facility there can be no automatic contagion between exposures. Nevertheless, where a significant part of the total exposure of an obligor is in default the institution may consider it unlikely that other obligations of that obligor will be paid in full, without recourse to actions such as realising security. Therefore it is proposed that where institutions consider it appropriate they may define an additional indication of unlikeliness to pay and define a threshold in terms of a percentage of total credit obligations of an obligor that indicates when all exposures of an obligor should be considered defaulted.

Such additional indication of unlikeliness to pay may have the advantage of the alignment of the prudential rules with the supervisory reporting framework and in particular with the ITS on forbearance and non-performing exposures. Institutions may either use the same threshold as for the purpose of supervisory reporting (currently 20%) or specify a different level of threshold. Where institutions decide to use 20% or lower thresholds the consistency with the definition of non-performing exposures will be kept because all defaulted exposures have to be reported as non-performing.

3.7.3 Materiality threshold for joint exposures

Where the institution decides to apply the definition of default at the obligor level the treatment of joint exposures has to be specified. In order to ensure harmonised application of the default definition at the obligor level it is necessary to specify the general principles with regard to the treatment of joint exposures the guidelines.

It is proposed that in the case any of the indications of default specified in Article 178(1) of Regulation (EU) 575/2013 occurs on a joint exposure of two or more obligors all other joint exposures of the same set of obligors and all individual exposures of those obligors should be considered defaulted. The contagious effect of this default should not automatically spread to other joint exposures of individual obligors with another individuals or entities that are not involved in the exposure that has initially been defaulted.

On the other hand, in the case any of the indications of default specified in Article 178(1) of Regulation (EU) 575/2013 occurs on the exposure of an individual obligor the contagious effect of this default should not automatically spread to any joint exposures of that obligor with other individuals or entities. Nevertheless, the institution should assess such exposures for possible indications of unlikeliness to pay related with the default of one of the obligors. If however all individual obligors are in the defaulted status their joint exposure should also be considered defaulted.

In order to operationalise the above rules it has to be further specified how to apply materiality threshold in the case of joint exposures. Therefore it has been clarified that for the purpose of application to the materiality threshold a joint obligor, i.e. a specific set of individual obligors that commit to a joint exposure, should be treated as a different, separate obligor. This approach will ensure that the assessment of a joint exposure will not be diluted by the existence of other individual exposures.

3.8 Documentation, internal policies and risk management processes

3.8.1 Documentation

In order to ensure that the default definition is specified correctly and applied consistently for relevant types of exposures it has been specified in the draft guidelines that the documentation related with the application of the definition of default should include detailed operationalization of all indications of default. In particular, it should describe the processes, sources of information and responsibilities for the identification of particular indications of default, including automatic mechanisms and manual processes.

As any changes in the definition of data are likely to result in structural breaks in historical data it is proposed that institutions should keep a register of all current and past versions of the default definition starting at least from the date of application of these guidelines. If more than one definition of default is used in a banking group the scope of application of each definition should be clearly specified.

3.8.2 Internal governance

As the definition of default is particularly important for the IRB Approach and is the basis for estimation of all risk parameters, own funds requirements and expected loss calculation, specific requirements with regard to internal governance have been clarified for institutions that use the IRB Approach. In order to ensure that the default definition is implemented in a correct manner it should be approved by the management body or by a committee designated thereof and senior management in line with Article 189 of Regulation (EU) 575/2013. Furthermore, in order to provide clarification on the so called ‘use test’ requirements specified in Article 144 of this Regulation it is proposed that these institutions should use the definition of default consistently for the purpose of own funds requirement calculation and internal risk management processes at least in the area of monitoring of exposures and internal reporting to senior management and management body. Finally, the internal audit or another comparable independent auditing unit should review regularly the robustness and effectiveness of the process used by the institution for the identification of default of an obligor in accordance with Article 191 of Regulation (EU) 575/2013.

4. Draft guidelines

In between the text of the Guidelines that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

EBA/GL-REC/20XX/XX

DD Month YYYY

Draft Guidelines

on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013

1. Compliance and reporting obligations

Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010[1]. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities and financial institutions must make every effort to comply with the guidelines.

2. Guidelines set the EBA view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. Competent authorities as defined in Article 4(2) of Regulation (EU) No 1093/2010 to whom guidelines apply should comply by incorporating them into their practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

Reporting requirements

3. According to Article 16(3) of Regulation (EU) No 1093/2010, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by ([dd.mm.yyyy]). In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form available on the EBA website to compliance@eba.europa.eu with the reference 'EBA/GL/201x/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities. Any change in the status of compliance must also be reported to EBA.

4. Notifications will be published on the EBA website, in line with Article 16(3).

[1] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, (OJ L 331, 15.12.2010, p.12).

2. Subject matter, scope and definitions

Subject matter

5. These guidelines specify the requirements on the application of Article 178 of Regulation (EU) No 575/2013 on the definition of default, in accordance with the mandate conferred to the EBA in Article 178(7) of that Regulation.

Scope of application

6. These guidelines apply in relation to both of the following:

   (a) the Internal Ratings Based Approach (IRB Approach) in accordance with Part Three, Title II, Chapter 3 of Regulation (EU) No 575/2013;

   (b) the Standardised Approach for credit risk by virtue of the reference to Article 178 in Article 127 of Regulation (EU) No 575/2013.

7. Institutions that have received permission to use the IRB Approach should apply the requirements set out in these guidelines for the IRB Approach to all exposures. Where those institutions have received prior permission to permanently use the Standardised Approach in accordance with Article 150 of Regulation (EU) No 575/2013, or permission to implement the IRB Approach sequentially in accordance with Article 148 of that Regulation, may apply the requirements set out in these guidelines for the Standardised Approach for the relevant exposures under permanent partial use of the Standardised Approach or included in the sequential implementation plan.

Addressees

8. These guidelines are addressed to competent authorities as defined in point (i) of Article 4(2) of Regulation (EU) No 1093/2010 and to financial institutions as defined in Article 4(1) of Regulation No 1093/2010.

Definitions

9. Unless otherwise specified, terms used and defined in Regulation (EU) No 575/2013 and Directive (EU) 36/2013 have the same meaning in these guidelines.

3. Implementation

Date of application

10. These guidelines apply from [XXX], therefore institutions should incorporate the requirements of these guidelines in their internal procedures and IT systems by that time, but competent authorities may accelerate the timeline of this transition at their discretion.

First application of the Guidelines by IRB institutions

11. In order to apply these guidelines for the first time, institutions that use the IRB Approach should assess and accordingly adjust, where necessary, their rating systems so that the estimates of risk parameters reflect the new definition of default according to these guidelines by applying the following:

    (a) where possible, adjust the historical data based on the new definition of default according to these guidelines, including in particular as a result of the materiality thresholds for past due credit obligations referred to in point (d) of Article 178(2) of Regulation (EU) No 575/2013;

    (b) assess the materiality of impact on all risk parameters and own funds requirements of the new definition of default according to these guidelines and compared to the previous definition, where applicable, after the relevant adjustments in historical data;

    (c) include an additional margin of conservatism in their rating systems in order to account for the possible distortions of risk estimates resulting from the inconsistent definition of default in the historical data used for modelling purposes.

12. The changes referred to in paragraph 11, which are applied to the rating systems as a result of the application of these guidelines, are required to be verified by the internal validation function and classified according to Commission Delegated Regulation (EU) No 529/2014, and, depending on this classification, they are required to be notified or approved by the relevant competent authority.

13. Institutions that use the IRB Approach, and which need to obtain prior permission from competent authorities in accordance with Article 143 of Regulation (EU) No 575/2013 and Commission Delegated Regulation (EU) No 529/2014[2] in order to incorporate these guidelines by the deadline referred to in paragraph 11, should submit the application for the

[2] OJ L 148, 20.5.2014, p. 36.

approval of changes in the definition of default to competent authorities at least one year before the date of application of these guidelines and by [XXX] at the latest.

14. After IRB institutions have started collecting data according to the new definition of default as provided in these guidelines, in the course of their regular revision of risk estimates referred to in Article 179(1)(c) of Regulation (EU) No 575/2013, those institutions should extend or, where justified, move the window of historical data used for the risk quantification to include new data. Until an adequate time period with homogenous default definition is reached, those IRB institutions, during their regular revisions of the risk parameter estimates, should assess the adequacy of the level of the margin of conservatism referred to in point (b) of paragraph 11.

Repeal

15. Sections 3.3.2.1. and 3.4.4. of the CEBS Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches (GL10) published on 4 April 2006 are repealed with effect from [XXX].

4. Past due criterion in the identification of default

16. For the purposes of the application of point (b) of Article 178(1) of Regulation (EU) No 575/2013, where any amount of principal, interest or fee has not been paid at the date it was due, institutions should recognise this as the credit obligation past due .

17. Where the credit arrangement explicitly allows the obligor to change the schedule, suspend or postpone the payments under certain conditions and the obligor acts within the rights granted in the contract, the changed, suspended or postponed instalments should not be considered past due, but the counting of days past due should be based on the new schedule once it is specified. Nevertheless if the obligor changes the schedule, suspends or postpones the payments, the institutions should analyse the reasons for such a change and assess the possible indications of unlikeliness to pay, in accordance with Articles 178(1) and (3) of Regulation (EU) No 575/2013 and Section 5 of these guidelines.

18. Where the repayment of the obligation is suspended because of a law allowing this option or other legal restrictions, the counting of days past due should also be suspended during that period. Nevertheless, in such situations, institutions should analyse, where possible, the reasons for exercising the option for such a suspension and should assess the possible

indications of unlikeliness to pay, in accordance with Articles 178(1) and (3) of Regulation (EU) No 575/2013 and Section 5 of these guidelines.

19. The sum of all amounts past due that are related to any credit obligation of the obligor to the institution, parent undertaking or any of its subsidiaries to this obligor and which institutions are required to calculate for the purpose of comparison with the materiality threshold set by the competent authority in accordance with point (d) of Article 178(2) of Regulation (EU) No 575/2013 should be calculated on a daily basis.

20. The classification of the obligor to a defaulted status should not be subject to additional expert judgement; once the obligor meets the past due criterion all exposures to that obligor are considered defaulted, unless the exposures are eligible as retail exposures and the institution applies the default definition at individual credit facility level. A so called 'technical default' should only be considered to have occurred in either of the following cases:

    (a) where an institution identifies that the defaulted status was a result of data or system error, including manual errors of standardised processes but excluding wrong credit decisions;

    (b) where due to the nature of the transaction there is a time lag between the receipt of the payment by an institution and the allocation of that payment to the relevant account, so that the payment was made before the 90 days and the crediting in the client's account took place after the 90 days past due.

    Technical defaults should not be considered as defaults in accordance with Article 178 of Regulation (EU) No 575/2013. All detected errors that led to technical defaults should be rectified by institutions in the shortest timeframe possible.

    In the case of institutions that use the IRB Approach technical defaults should be removed from the reference data set for the purpose of estimation of risk parameters.

Explanatory text for consultation purposes

As the notion 'technical defaults' is commonly used by many institutions but there are various practices with regard to the definition and treatment of technical defaults it is proposed that clarification should be provided in these guidelines. The proposed approach allows considering credit obligations as technically past due only when the delay results from data or system errors or lengthy payment allocation processes within the institution. As in these cases the material delay in payment has in fact not occurred, such exposures should not be considered defaulted for the purpose of estimation of risk parameters in order not to bias the estimates.

In all other situations where the past due materiality threshold is breached the exposures should be classified as defaulted, even if the delay in payment is related to non-financial reasons. The rationale behind this is that as a general rule non-financial circumstances should be resolved within the first 90 (or where applicable 180) days past due. Beyond that time horizon the technical past due should be already sufficiently filtered by the materiality threshold and the CRR does not allow any other exceptions for the recognition of default.

Question 1: Do you agree with the proposed definition of technical defaults? Do you believe that other situations should be included in this definition? If yes, please provide detailed proposals on how to address further possible situations.

21. Where there are modifications of the schedule of credit obligations, as referred to in point (e) of Article 178(2) of Regulation (EU) No 575/2013, the institution's policies should clarify that the counting of days past due should be based on the modified schedule of payments.

22. Where there are factoring arrangements whereby the risks and benefits related with the ceded receivables are not fully transferred to the factor and the factor is liable directly to the client up to a certain agreed percentage, the counting of days past due should commence from when the factoring account is in debit, i.e. from when the advances paid for the receivables exceed the percentage agreed between the factor and the client. For the purpose of determining items of the client of a factor that are past due, institutions should apply both of the following:

    (a) compare the sum of the amount of the factoring account that is in debit and all other past due obligations of the client recorded in the balance sheet of the factor, against the absolute component of the threshold;

    (b) compare the relation between the sum described in point (a) and the total amount of current value of the factoring account, i.e. the value of advances paid for the receivables and all other on-balance sheet exposures related with the credit obligations of the client, against the relative component of the threshold.

23. Where there are factoring arrangements where the risks and benefits related with the ceded receivables are fully transferred to the factor and the factor has exposures to the debtors of the client, the counting of days past due should commence when the payment for a single receivable becomes due. In this situation, for institutions that use the IRB Approach, by virtue of the fact that the ceded receivables are purchased receivables, where they meet the requirements of 154(5) of Regulation (EU) No 575/2013 or in the case of purchased corporate receivables the requirements of Article 153(6) of Regulation (EU) No 575/2013, the default definition may be applied as for retail exposures in accordance with Section 9 of these guidelines.

Explanatory text for consultation purposes

Due to specific characteristics of factoring contracts, the accounting treatment of such arrangements differs depending on whether they are related with full transfer of risks and benefits related with the ceded receivables to the factor or not. Taking into account that prudential treatments applies to all exposures according to their accounting value the treatment of factoring arrangements for prudential purposes should also be differentiated. In particular, where the invoices to individual debtors are recorded on the balance sheet of the factor, these invoices should be treated as separate exposures in the form of purchased receivables. Where however only the settlements with the client are reflected in the balance sheet of the factor, this should be treated as an exposure of the factor to this client. However, also in this situation a general rule would apply that the materiality threshold should apply at the obligor level. Therefore, if the client has also other obligations towards the factor recorded on the factor's balance sheet, these obligations should be taken into account in the application of the materiality threshold for past due exposures.

Question 2: Do you consider the requirements on the treatment of factoring arrangements as appropriate and sufficiently clear? If not, please provide proposals for additional clarifications.

5. Indications of unlikeliness to pay

Non-accrued status

24. For the purposes of unlikeliness to pay as referred to in point (a) of Article 178(1) of Regulation (EU) No 575/2013, institutions should consider that an obligor is unlikely to pay where interest related with credit obligations are no longer recognised in the income statement of the institution due to the decrease of a credit quality of the obligation.

Specific credit risk adjustments (SCRA)

25. For the purposes of unlikeliness to pay as referred to in point (b) of Article 178(3) of Regulation (EU) No 575/2013, all of the following SCRA should be considered to be a result of a significant perceived decline in the credit quality of a credit obligation and hence should be treated as an indication of unlikeliness to pay:

    (a) losses recognised in the profit or loss account for instruments measured at fair value that represent credit risk impairment under the applicable accounting framework;

    (b) losses as a result of current or past events affecting a significant individual exposure or exposures that are not individually significant which are individually or collectively assessed.

26. The SCRA that cover the losses for which historical experience, adjusted on the basis of current observable data, indicate that the loss has occurred but the institution is not yet aware which individual exposure has suffered these losses ('incurred but not reported losses'), should not be considered an indication of unlikeliness to pay of a specific obligor.

27. Where the institution treats an exposure as impaired such a situation should be considered an additional indication of unlikeliness to pay and hence the obligor should be considered defaulted regardless of whether there are any SCRA assigned to this exposure. Where in accordance with the applicable accounting framework in the case of incurred but not reported losses exposures are recognised as impaired, these situations should not be treated as an indication of unlikeliness to pay.

28. Where the institution treats an exposure as credit-impaired under IFRS 9, i.e. assigns it to Stage 3 as defined in IFRS 9 Financial Instruments which was published by the IASB in July 2014, such exposure should be considered defaulted, except where the exposure has been assigned to Stage 3 due to the delay in payment and either or both of the following conditions are met:

    (a) the competent authorities have replaced the 90 days past due with 180 days past due in accordance with point (b) of Article 178(1) of Regulation EU (No) 575/2013 and this longer period is not used for the purpose of classification of exposures to Stage 3;

    (b) the materiality threshold referred to in Article 178(2)(d) of Regulation (EU) No 575/2013 has not been breached.

29. Where the institution uses both IFRS 9 and another accounting framework it should choose whether to classify exposures as defaulted in accordance with paragraphs 25 to 27 or in accordance with paragraph 28. Once this choice is made it should be applied consistently over time.

Explanatory text for consultation purposes

In order to ensure harmonised application of the definition of default it is considered appropriate to specify clear rules for the treatment of SCRA that would not require additional expert judgement. The proposal is based on the RTS on the specification of the calculation of the specific and general credit risk adjustments. It has been assumed that in the case the losses are considered already incurred and the institution has identified specific exposures on which the losses have been incurred, those exposures should be considered defaulted. This assumption extends also to situations where the amount of provisions is calculated collectively for a certain portfolio but all exposures in this portfolio are expected to lead to losses for the bank.

Additionally, as it is expected that revised accounting framework (IFRS 9) will be applied by many institutions from 1 January 2018, specific treatment of provisions created according to these new rules have also been defined. It is assumed that all provisions created for exposures classified to Stage 3 should be treated as SCRA resulting from a significant perceived decline in the credit quality of an obligation. As the indications of credit-impairment as specified in the accounting framework are subject to assessment by the institutions it is considered appropriate to treat all credit-impaired exposure as defaulted.

It is assumed that as a general rule where 180 days past due are used 90 days for the purpose of the definition of default this longer period will also be recognised for the purpose of classification of exposures to Stage 3. However, an exception has been added to the general rule in order to account for possible situations where 180 days past due definition, although used in the prudential framework, will not be accepted for the accounting purposes.

Question 3: Do you agree with the approach proposed for the treatment of specific credit risk adjustments?

Sale of the credit obligation

30. For the purposes of unlikeliness to pay as referred to in point (c) of Article 178(3) of Regulation (EU) No 575/2013, institutions should take into account both the character and materiality of the loss related with the sale of credit obligations, in accordance with the following paragraphs.

31. Institutions should analyse the reasons for the sale of credit obligations and the reasons for any losses recognised thereby. Where the reasons for the sale of credit obligations were not related to credit risk, such as where there is the need to increase the liquidity of the institution or there is a change in business strategy, and the institution does not perceive the credit quality of those obligations as declined, the economic loss related with the sale of those obligations should be considered not credit-related. In that case the sale should not be considered an indication of default even where the loss is material, on condition of the appropriate, documented justification of the treatment of the sale loss as not credit-related.

32. Where however the loss on the sale of credit obligations is related to the credit quality of these obligations, in particular where the institution sells the credit obligations due to the decrease in their quality, the institution should analyse the materiality of the economic loss and, where the economic loss is material, this should be considered an indication of default.

33. Institutions should set a threshold for the credit-related economic loss related with the sale of credit obligations to be considered material, which should be calculated according to the following formula, and should not be higher than [5%]:

$$L = \frac{E - P}{E}$$

where:

L is the economic loss related with the sale of credit obligations;

E is the total outstanding amount of the obligations subject to the sale, including interest and fees;

P is the price agreed for the sold obligations.

34. In order to assess the materiality of the overall economic loss related with the sale of credit obligations, institutions should calculate the economic loss and compare it to the threshold referred to in paragraph 33. Where the economic loss is higher than this threshold they should consider the credit obligations defaulted.

35. The sale of credit obligations may be performed either before or after the default. In the case of institutions that use the IRB Approach, regardless of the moment of the sale, if the sale was related with a material credit-related economic loss, the information about the loss should be adequately recorded and stored for the purpose of the estimation of risk parameters.

36. If the sale of a credit obligation at a material credit-related economic loss occurred before the identification of default on that exposure, the moment of sale should be considered the moment of default. In the case of a partial sale of the total obligations of an obligor where the sale is associated to a material credit-related economic loss, all the remaining exposures to this obligor should be treated as defaulted, unless the exposures are eligible as retail exposures and the institution applies the default definition at facility level.

37. In the case of a sale of a portfolio of exposures the treatment of individual credit obligations within this portfolio should be determined in accordance with the manner the price for the portfolio was set. Where the price for the total portfolio was determined by specifying the discount on particular credit obligations, the materiality of credit-related economic loss should be assessed individually for each exposure within the portfolio. Where however the price was set only at the portfolio level, the materiality of credit-related economic loss may be assessed at the portfolio level and in that case, if the threshold specified in paragraph 33 is breached, all credit obligations within this portfolio should be treated as defaulted at the moment of the sale.

Explanatory text for consultation purposes

According to the proposal for the treatment of the sale of credit obligations the assessment of the loss is performed in relation to the outstanding amount of the obligations subject to the sale. As a result, in the case of an instrument that was bought at a discount (for example a bond), the assessment of the materiality of the loss would relate to the total amount owed by the obligor at the date of a sale rather than to the price paid for this instrument by an institution.

Question 4: Do you consider the proposed treatment of the sale of credit obligations appropriate for the purpose of identification of default?

Distressed restructuring

38. For the purposes of unlikeliness to pay as referred to in point (d) of Article 178(3) of Regulation (EU) No 575/2013, a distressed restructuring should be considered to have occurred when concessions have been extended towards a debtor facing or about to face difficulties in meeting its financial commitments as specified in paragraphs 163-167 and 172-174 of Annex V Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014[3] as amended by Commission Implementing Regulation (EU) 2015/227[4].

39. Given that, as referred to in point (d) of Article 178(3) of Regulation (EU) No 575/2013, the obligor should be considered defaulted where the distressed restructuring is likely to result in a diminished financial obligation, where considering forborne exposures, the obligor should be classified as defaulted only where the relevant forbearance measures are likely to result in a diminished financial obligation.

[3] OJ L 191, 28.6.2014, p. 1.

[4] OJ L 48, 20.2.2015, p. 1.

40. Institutions should set a threshold for the diminished financial obligation that is considered to be caused by material forgiveness or postponement of principal, interest, or fees, and which should be calculated according to the following formula, and should not be higher than [1%]:

$$DO = \frac{NPV_0 - NPV_1}{NPV_0}$$

where:

DO is diminished financial obligation;

NPV_0 is net present value of expected cash flows (including unpaid interest and fees) before the changes in terms and conditions of the contract discounted using the customer's original effective interest rate;

NPV_1 is net present value of the expected cash flows based on the new arrangement discounted using the customer's original effective interest rate.

41. For the purposes of unlikeliness to pay as referred to in point (d) of Article 178(3) of Regulation (EU) No 575/2013, for each distressed restructuring, institutions should calculate the diminished financial obligation and compare it with the threshold referred to in paragraph 40. Where the diminished financial obligation is higher than this threshold, the exposures should be considered defaulted.

Explanatory text for consultation purposes

It is proposed that in order to assess whether the financial obligation has diminished as a result of distressed restructuring institutions should discount the expected cash flows using the customer's original effective interest rate. An alternative option was also considered to use the effective interest rate applicable at the moment before signing the restructuring arrangements (i.e. the one that would have to be paid for the credit obligation without taking the restructuring into account). It is assumed that this interest rate would be readily available for all institutions and might be more relevant for the assessment of the financial obligation at the moment of restructuring arrangements.

In the end, the use of the customer's original effective interest rate has been considered the preferred option as this approach ensures an alignment with the accounting framework where original effective interest rate is used for the purpose of impairment test.

Question 5: Do you agree that expected cash flows before and after distressed restructuring should be discounted with the customer's original effective interest rate or would you prefer to use the effective interest rate applicable at the moment before signing the restructuring arrangement? Do you consider the specification of the interest rate used for discounting of cash flows sufficiently clear?

42. If however the diminished financial obligation is below the specified threshold, and in particular when the net present value of expected cash flows based on the distressed restructuring arrangement is higher than the net present value of expected cash flows before the changes in terms and conditions, institutions should assess such exposures for other

possible indications of unlikeliness to pay. Where the institution has reasonable doubts with regard to the likeliness of repayment in full of the obligation according to the new arrangement in a timely manner, the obligor should be considered defaulted. The indicators that may suggest unlikeliness to pay include the following:

(a) a large lumpsum payment envisaged at the end of the repayment schedule;

(b) irregular repayment schedule where significantly lower payments are envisaged at the beginning of repayment schedule;

(c) significant grace period at the beginning of the repayment schedule.

43. Any concession extended to an obligor already in default, should lead to classify the obligor as a distressed restructuring. All exposures classified as forborne non-performing in accordance with Annex V of Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 as amended by Commission Implementing Regulation (EU) 2015/227 should be classified as default and subject to distressed restructuring.

44. Where any of the modifications of the schedule of credit obligations referred to in point (e) of Article 178(2) of Regulation (EU) No 575/2013 is the result of financial difficulties of an obligor, institutions should also assess whether a distressed restructuring has taken place and whether an indication of unlikeliness to pay has occurred.

Bankruptcy

45. For the purposes of unlikeliness to pay as referred to in point (e) and (f) of Article 178(3) of Regulation (EU) No 575/2013, institutions should clearly specify what type of arrangement is treated as an order or as a protection similar to bankruptcy, taking into account all relevant legal frameworks. Typically the characteristics of such protection include the following:

(a) the protection scheme encompasses all creditors;

(b) the terms and conditions of the protection scheme are approved by the court or other relevant public authority;

(c) the terms and conditions of the protection scheme include a temporary suspension of payments or partial redemption of debt;

(d) the measures involve some sort of control over the management of the company and its assets;

(e) if the protection scheme fails, the company is likely to be liquidated.

Other indications of unlikeliness to pay

46. Institutions should specify in their internal policies and procedures other additional indications of unlikeliness to pay of an obligor, besides those specified in Article 178(3) of Regulation (EU) No 575/2013. Those additional indications should be specified per type of exposures, as defined in point (2) of Article 142(1) of Regulation (EU) No 575/2013, reflecting their specificities, and they should be specified for all business lines, legal entities or geographical locations. The occurrence of an additional indication of unlikeliness to pay should either result in an automatic reclassification to defaulted exposures or trigger a case-by-case assessment and may include indications based on internal or external information.

47. The possible indications of unlikeliness to pay that could be considered by institutions on the basis of internal information include the following:

    (a) a borrower's sources of recurring income are no longer available to meet the payments of instalments;

    (b) there are justified concerns about a borrower's future ability to generate stable and sufficient cash flows;

    (c) the borrower's overall leverage level has significantly increased or there are justified expectations of such changes to leverage;

    (d) the borrower has breached the covenants of a credit contract;

    (e) the institution has called any collateral including a guarantee;

    (f) for the exposures to an individual: default of a company fully owned by a single individual where this individual provided the institution with a personal guarantee for all obligations of a company;

    (g) a financial asset was purchased or originated at a material discount that reflects the deteriorated credit quality of the debtor;

    (h) for retail exposures where the default definition is applied at the level of an individual credit facility, the fact that a significant part of the total obligation of the obligor is in default;

    (i) the reporting of an exposure as non-performing in accordance with Annex V of Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 as amended by Commission Implementing Regulation (EU) 2015/227, except where competent authorities have replaced the 90 days past due with 180 days past due in accordance with point (b) of Article 178(1) of Regulation EU (No) 575/2013.

Explanatory text for consultation purposes

When a financial asset is purchased or originated at a discount it is booked in the institution’s balance sheet at a discounted value and there is no impairment adjustment. Nevertheless, the original credit obligation remains valid and the institution may request the repayment of full amount from the obligor. As the purchase of the obligation at a material discount indicates that the institution expects that the obligation will probably not be paid in full such situation should be treated as an indication of default.

Question 6: Do you agree that the purchase or origination of a financial asset at a material discount should be treated as an indication of unlikeliness to pay?

48. Institutions should also take into account the information available in external databases, including credit registers, macroeconomic indicators and public information sources, including press articles and financial analyst’s reports. The indications of unlikeliness to pay that could be considered by institutions on the basis of external information include the following:

    (a) significant delays in payments to other creditors have been recorded in the relevant credit register;

    (b) a crisis of the sector in which the counterparty operates combined with a weak position of the counterparty in this sector;

    (c) disappearance of an active market for a financial asset because of the financial difficulties of the debtor;

    (d) an institution has information that a third party, in particular another institution, has filed for bankruptcy or similar protection of the obligor.

49. When specifying the criteria for unlikeliness to pay, institutions should take into consideration the relations within the groups of connected clients as defined in point 39 of Article 4(1) of Regulation (EU) No 575/2013. In particular institutions should specify in their internal policies when the default of one obligor within the group of connected clients has a contagious effect on other entities within this group. Such specifications should be in line with the appropriate policies for the assignment of exposures to individual obligor to an obligor grade and to groups of connected clients in accordance with point (d) of Article 172(1) of Regulation (EU) No 575/2013. Where such criteria have not been specified for a non-standard situation, in the case of default of an obligor that is part of a group of connected clients, institutions should assess the potential unlikeliness to pay of all other entities within this group on a case-by-case basis.

50. Institutions should have adequate policies and procedures to identify credit frauds. Typically when credit fraud is identified, the exposure is already defaulted on the basis of material delays in payment. However, if the credit fraud is identified before default has been recognised this should be treated as an additional indication of unlikeliness to pay.

Governance processes regarding unlikeliness to pay

51. Institutions should establish policies regarding the definition of default in order to ensure its consistent and effective application and in particular they should have clear policies and procedures on the application of the criteria for unlikeliness to pay as laid down in Article 178(3) of Regulation (EU) No 575/2013 and all other indications of unlikeliness to pay as specified by the institution, covering all types of exposures as defined in point (2) of Article 142(1) of Regulation (EU) No 575/2013, for all business lines, legal entities and geographical locations.

52. With regard to each indication of unlikeliness to pay institutions should define the adequate methods of their identification, including the sources of information and frequency of monitoring. The sources of information should include both internal and external sources, including in particular relevant external databases and registers.

6. Application of the definition of default in external data

53. Institutions that use the IRB Approach and use external data for the purpose of estimation of risk parameters in accordance with Article 178(4) of Regulation (EU) No 575/2013 should apply the requirements specified in this section.

54. For the purposes of Article 178(4) of Regulation (EU) No 575/2013 institutions should do all of the following:

    (a) verify whether the definition of default used in the external data is in line with Article 178 of Regulation (EU) 575/2013;

    (b) verify whether the definition of default used in external data is consistent with the definition of default as implemented by the institution for the relevant portfolio of exposures, including in particular: the counting and number of days past due that triggers default, the structure and level of materiality threshold for past due credit obligations, the definition of distressed restructuring that triggers default, the type and level of specific credit risk adjustments that triggers default and the criteria to return to non-defaulted status;

    (c) document sources of external data, the default definition used in external data, the performed analysis and all identified differences.

55. For each difference identified in the definition of default resulting from the assessment of paragraph 54, institutions should do all of the following:

    (a) assess whether the adjustment to the internal definition of default would lead to an increased or a decreased default rate or whether it is impossible to determine;

    (b) either perform appropriate adjustments in the external data or be able to demonstrate that the difference is negligible in terms of the impact on all risk parameters and own funds requirements,

56. Regarding the totality of the differences identified in the definition of default resulting from the assessment of paragraph 54 and taking into account the adjustments performed in accordance with point (b) of paragraph 55, institutions should be able to demonstrate to competent authorities that broad equivalence with the internal definition of default has been achieved, including, where possible by comparing the default rate in internal data on a relevant type of exposures with external data.

57. Where the assessment of paragraph 54 identifies differences in the definition of default which the process of paragraph 55 reveals to be non-negligible but not possible to overcome by adjustments in the external data, institutions are required to adopt an appropriate margin of conservatism in the estimation of risk parameters as referred to in Article 179(1)(f) of Regulation (EU) No 575/2013. In that case institutions should ensure that this additional margin of conservatism reflects the materiality of the remaining differences in the definition of default and their possible impact on all risk parameters.

7. Criteria for the return to a non-defaulted status

Minimum conditions for reclassification to a non-defaulted status

58. For the purposes of the application of Article 178(5) of Regulation (EU) 575/2013, except for situations referred to in paragraph 59, institutions should apply all of the following:

    (a) consider that no trigger of default continues to apply to a previously defaulted exposure, where at least 3 months have passed since the moment that the conditions referred to in Articles 178(1)(b) and 178(3) of Regulation (EU) No 575/2013 were no longer met;

    (b) take into account the behaviour of the obligor during the period referred to in point (a);

(c) take into account the financial situation of the obligor during the period referred to in point (a);

(d) after the period referred to in point (a), perform an assessment, and, where the institution still finds that the obligor is unlikely to pay its obligations in full without recourse to realising security, the exposures should continue to be classified as defaulted until the institution is satisfied that the improvement of the credit quality is factual and permanent;

(e) the conditions referred to in points (a) to (d) should be met also with regard to new exposures to the obligor, in particular where the previous defaulted exposures to this obligor were sold or written off.

59. For the purposes of the application of Article 178(5) of Regulation (EU) 575/2013, and where distressed restructuring according to paragraph 38 of these guidelines applies to a defaulted exposure, regardless of whether such restructuring was carried out before or after the identification of default, institutions should consider that no trigger of default continues to apply to a previously defaulted exposure, where at least 1 year has passed from the latest between one of the following events:

(a) the moment of extending the restructuring measures;

(b) the moment when the exposure has been classified as defaulted;

(c) the end of the grace period included in the restructuring arrangements.

60. Institutions should reclassify the exposure to a non-defaulted status after at least the one year period referred to in the previous paragraph, where all of the following conditions are met:

(a) during that period a material payment has been made by the obligor; material payment may be considered to be made where the debtor has paid, via its regular payments in accordance with the restructuring arrangements, a total equal to the amount that was previously past-due (if there were past-due amounts) or that has been written-off (if there were no past-due amounts) under the restructuring measures;

(b) during that period the payments have been made regularly according to the schedule applicable after the restructuring arrangements;

(c) there are no past due credit obligations according to the schedule applicable after the restructuring arrangements;

(d) no indications of unlikeliness to pay as specified in Article 178(3) of Regulation (EU) No 575/2013 or any additional indications of unlikeliness to pay specified by the institution apply;

(e) the institution does not consider it otherwise unlikely that the obligor will pay its credit obligations in full according to the schedule after the restructuring arrangements without recourse to realising security. In this assessment institutions should examine in particular situations where a large lumpsum payment or significantly larger payments are envisaged at the end of the repayment schedule;

(f) the conditions referred to in points (a) to (e) should be met also with regard to new exposures to the obligor, in particular where the previous defaulted exposures to this obligor that were subject to distressed restructuring were sold or written off.

Explanatory text for consultation purposes

A probation period of at least 3 months is proposed in order to avoid frequent changes of statuses of exposures and as a result excessive number of multiple defaults. In particular, in the case of delays in payment when the indication specified in Article 178(1)(b) ceases to apply the credit obligation may still be past due more than 90 days but the amount past due is considered immaterial or the credit obligation might be past due less than 90 days with a material amount. Such situation in connection with the recent default indicates that it is unlikely that the obligation will be paid in full according to the agreed schedule. Therefore it is necessary to specify a probation period during which the institution should assess whether the situation of the obligor has improved permanently in a way that it is no longer unlikely that the obligation will be paid in full according to the agreed schedule.

The obligation that has once been restructured under distressed conditions remains to be restructured until the obligation is paid in full. Therefore more prudent approach has to be adopted with regard to the assessment of the repayments. It is proposed that in the case of distressed restructuring the probation period should be at least 1 year, which is in line with the rule adopted for the purpose of supervisory reporting in the ITS on forbearance and non-performing exposures.

Question 7: What probation periods before the return from default to non-defaulted status would you consider appropriate for different exposure classes and for distressed restructuring and all other indications of default?

Monitoring of the effectiveness of the policy

61. For the purposes of the application of Article 178(5) of Regulation (EU) 575/2013, an institution should define clear criteria and policies regarding when the obligor can be classified back to non-defaulted status and more in particular, both of the following:

    (a) when it can be considered that the improvement of the financial situation of an obligor is sufficient to allow the full and timely repayment of the credit obligation;

    (b) when the repayment is actually likely to be made even where there is an improvement in the financial situation of an obligor in accordance with point (a).

62. Institutions should monitor on a regular basis the effectiveness of their policies mentioned in paragraph 61, and in particular monitor and analyse:

(a) the changes of status of the obligors or facilities;

(b) the impact of the adopted policies on cure rates;

(c) the impact of adopted policies on multiple defaults.

63. It is expected that the institution would have a limited number of obligors who default soon after returning to a non-defaulted status. In the case of extensive number of multiple defaults the institution should revise its policies with regard to the reclassification of exposures.

64. The analysis of the changes in statuses of the obligors or facilities should in particular be taken into account for the purpose of specifying the periods referred to in paragraphs 58 and 59. Institutions may specify longer periods for the exposures that have been classified as defaulted in the preceding 24 months.

8. Consistency in the application of the definition of default

Overview

65. Institutions should adopt adequate mechanisms and procedures in order to ensure that the definition of default is implemented and used in a correct manner, and should, in particular, ensure:

(a) that default of a single obligor is identified consistently across the institution with regard to all exposures to this obligor in all relevant IT systems, including in all the legal entities within the group and in all geographical locations in accordance with paragraphs 66 to 68 or for retail exposures in accordance with paragraphs 78 to 81;

(b) that one of the following applies:

(i) the same definition of default is used consistently by an institution, parent undertaking or any of its subsidiaries and across the types of exposures;

(ii) where different definitions of default apply either within a group or across the types of exposures, the scope of application of each of the default definitions is clearly specified, in accordance with paragraphs 69 to 71;

Consistent identification of default of a single obligor

66. For the purposes of point (a) of paragraph 65, institutions should implement adequate procedures and mechanisms to ensure that the default of a single obligor is identified consistently across the institution with regard to all exposures to this obligor in all relevant IT systems, including in all the legal entities within the group and in all geographical locations where it is active in ways other than via a legal entity.

67. Where the exchange of client data among different legal entities within an institution, the parent undertaking or any of its subsidiaries is prohibited by consumer protection regulations, bank secrecy or other legislation resulting in inconsistencies in the identification of default of an obligor, institutions should inform their competent authorities of these legal impediments and, if they use the IRB Approach they should also estimate the materiality of the inconsistencies in the identification of default of an obligor and their possible impact on the estimates of risk parameters.

68. Further, where the identification of default of an obligor in a manner fully consistent across the institution, the parent undertaking or any of its subsidiaries is very burdensome, requiring development of a centralised database of all clients or implementation of other mechanisms or procedures to verify the status of each client at all entities within the group, institutions need not apply such mechanisms or procedures if they can demonstrate that the effect of non-compliance is immaterial because there are no or very limited number of common clients among the relevant entities within a group and the exposure to these clients is immaterial.

Consistent use of the definition of default across types of exposures

69. For the purposes of point (b) of paragraph 65, an institution, parent undertaking or any of its subsidiaries should use the same definition of default for a single type of exposures as defined in point (2) of Article 142(1) pf Regulation (EU) No 575/2013. They may use different definitions of default for different types of exposures, including for certain legal entities or for presence in geographical locations in ways other than via a legal entity, where this is justified by the application of significantly different internal risk management practices or by different legal requirements applying in different jurisdictions, in particular by reasons such as:

    (a) different materiality thresholds set by competent authorities in their jurisdictions in accordance with point (d) of Article 178(2) of Regulation (EU) No 575/2013;

    (b) the use of 180 days instead of 90 days past due for certain types of exposures to which the IRB Approach is applied in some jurisdictions in accordance with point (b) of Article 178(1) of Regulation (EU) No 575/2013;

    (c) the specification of additional indications of unlikeliness to pay specific for certain legal entities, geographical locations or types of exposures.

70. For the purposes of point (b)(ii) of paragraph 65, and where different definitions of default are applied either across types of exposures in accordance with paragraph 69, the institutions' internal procedures relating to the definition of default should ensure both of the following:

    (a) that the scope of application of each definition is clearly specified;

    (b) that the definition of default specified for a certain type of exposures, legal entity or geographical location is applied consistently to all exposures within the scope of application of each relevant definition of default.

71. Further, for institutions that use the IRB Approach, the use of different default definitions has to be adequately reflected in the estimation of risk parameters in the case of ratings systems which scope of application encompasses different default definitions.

9. Application of the definition of default for retail exposures

Level of application of the default definition for retail exposures

72. According to the second sub-paragraph of Article 178(1) of Regulation (EU) No 575/2013, in the case of retail exposures, institutions may apply the definition of default at the level of an individual credit facility rather than in relation to the total obligations of a borrower. Therefore, institutions that use the IRB Approach, in particular, may apply the definition of default at the level of the individual facility for retail exposures as defined in Article 147(5) of Regulation (EU) 575/2013. Institutions that use the Standardised Approach, instead may apply the definition of default at the level of an individual credit facility for all exposures that meet the criteria specified in Article 123 of Regulation (EU) 575/2013, even where some of those exposures have been assigned to a different exposure class for the purpose of assigning a risk weight, such as exposures secured by mortgages on immovable property.

73. Institutions should choose the level of application of the definition of default between obligor and facility for all retail exposures in a way that reflects their internal risk management practices.

74. Institutions may apply the definition of default at the level of an obligor for some types of retail exposures and at the level of a credit facility for others, where this is well justified by internal risk management practices, for instance due to a different business model of a subsidiary, and where there is evidence that the number of situations where the same clients

are subject to different definitions of default at different levels of application is kept to a strict minimum.

75. Where institutions decide to use different levels of application of the definition of default for different types of retail exposures, according to paragraph 74, they should ensure that the scope of application of each definition of default is clearly specified and that it is used consistently over time for different types of retail exposures. In the case of institutions that use the IRB Approach the risk estimates should correctly reflect the definition of default applied to each type of exposures.

Explanatory text for consultation purposes

Where default definition is applied at the facility level for some exposures and at the obligor level for other exposures to the same obligor, the application of the definition at the obligor level only for a part of total exposure is not fully in line with the requirements of Article 178 of the CRR. It is possible in that case that one exposure to the obligor (assessed at the facility level) is defaulted whereas other exposures remain in the non-defaulted status. The obligor would have a different PD for different exposures even though the definition of default applies at the obligor level.

Therefore, as a general rule the same level of application of the definition of default should be used consistently for a specific set of clients. The level of application should be chosen in accordance with the internal risk management practices. In particular, where certain products are managed in a different way than the others, the definition of default should be applied at the facility level.

Nevertheless, where the facility level is used, institutions may still define additional indications of unlikeliness to pay based on the status of other exposures to the same obligor. For instance, institutions may adopt a rule that default of a mortgage loan results in default of all other exposures to the obligor.

Question 8: Do you agree with the proposed approach as regards the level of application of the definition of default for retail exposures?

76. Where institutions use different levels of application of the default definition with regard to certain retail portfolios, the treatment of common clients across such portfolios should be specified in their internal policies and procedures. In particular, where the exposure to which the definition of default at the obligor level applies fulfils either or both of the conditions of points (a) or (b) of Article 178(1) of Regulation (EU) No 575/2013, then all exposures to that obligor should be considered defaulted, including those subject to the application of the definition of default at individual credit facility level. Where the exposure subject to the application of the definition of default at individual credit facility level meets those conditions, the other exposures to the obligor should not be automatically reclassified to default status. Institutions, however, may classify those other exposures as defaulted on the basis of other unlikeliness to pay considerations, as provided further in paragraphs 78 to 80.

77. The same rule should apply to the obligors treated under the Standardised Approach, where some exposures to an obligor fulfil the requirements of Article 123 of Regulation (EU) 575/2013 while other exposures to the same obligor are in the form of securities and

therefore do not qualify as retail. Where an exposure in the form of a security fulfils either or both of the conditions of points (a) or (b) of Article 178(1) of Regulation (EU) No 575/2013, all exposures to that obligor should be considered defaulted. Where the exposure that fulfils the requirements of Article 123 of Regulation (EU) 575/2013 meets those conditions and the institution applies the definition of default at the individual credit facility level, the other exposures to the obligor should not be automatically reclassified to default status. Institutions, however, may classify those other exposures as defaulted on the basis of other unlikeliness to pay considerations, as provided further in paragraphs 78 to 80.

Application of the definition of default for retail exposures at the facility level

78. Where, in accordance with the second sub-paragraph of Article 178(1) of Regulation (EU) No 575/2013, the definition of default has been applied at the level of an individual credit facility with regard to retail exposures, institutions should not consider automatically the different exposures to the same obligor defaulted at the same time. Nevertheless institutions should take into account that some indications of default are related with the condition of the obligor rather than the status of a particular exposure. This refers in particular to the indications of unlikeliness to pay related with the bankruptcy of the obligor as specified in points (e) and (f) of Article 178(3) of Regulation (EU) No 575/2013. Where such indication of default occurs, institutions should treat all exposures to the same obligor as defaulted regardless of the level of application of the definition of default.

79. Institutions should consider also other indications of unlikeliness to pay and specify, in line with their internal policies and procedures, which indications of unlikeliness to pay reflect the overall situation of an obligor rather than that of the exposure. Where such other indications of unlikeliness to pay occur, all exposures to the obligor should be considered defaulted regardless of the level of application of the definition of default.

80. Additionally, where a significant part of the exposures to the obligor is in default, institutions may consider it unlikely that the other obligations of that obligor will be paid in full without recourse to actions such as realising security and treat them as defaulted as well.

Explanatory text for consultation purposes

The so called ‘pulling effect’ has been introduced for the purpose of supervisory reporting in the ITS on forbearance and non-performing exposures with the 20% threshold. This means that if 20% of exposures to one obligor are classified as non-performing all other exposures to this obligor should also be reported as non-performing.

As all defaulted exposures are required to be reported as non-performing the pulling effect is in practice only applicable to retail exposures where the definition of default is applied at the facility level. In all other cases, i.e. where the definition of default is applied at the obligor level, if one exposure is considered defaulted then all other exposures also have to be classified as defaulted and therefore all exposures to an obligor are classified as non-performing.

It is proposed that similar principle may be introduced for the purpose of definition of default in the prudential framework in the form of an additional indication of unlikeliness to pay. The rationale for introducing this rule would be that where the obligor is defaulted on a significant part of its exposures this indicates the unlikeliness to pay of the remaining credit obligations of this obligor. However, for the purpose of prudential framework it also has to be considered whether the additional defaults recognized as a result of pulling effect would not lead to excessive cure rates and decreased LGD estimates.

Question 9: Do you consider that where the obligor is defaulted on a significant part of its exposures this indicates the unlikeliness to pay of the remaining credit obligations of this obligor?

Application of the definition of default for retail exposures at the obligor level

81. The application of the definition of default for retail exposures at the obligor level implies that, where any credit obligation of the obligor meets the conditions of points (a) or (b) or both of Article 178(1) of Regulation (EU) No 575/2013, then all exposures to that obligor should be considered defaulted. Institutions that decide to apply the definition of default for retail exposures at the obligor level should specify detailed rules for the treatment of joint credit obligations and default contagion between exposures in their internal policies and procedures.

82. Institutions should consider a joint credit obligation as an exposure to two or more obligors that are equally responsible for the repayment of the credit obligation. This notion does not extend to a credit obligation of an individual obligor secured by another individual or entity in the form of a guarantee or other credit protection.

83. Where the conditions of points (a) or (b) or both of Article 178(1) of Regulation (EU) No 575/2013 are met with regard to a joint credit obligation of two or more obligors, institutions should consider all other joint credit obligations of the same set of obligors and all individual exposures to those obligors as defaulted. This default should not cause the default of other joint credit obligations of individual obligors with other individuals or entities, which are not involved in the credit obligation that has initially been defaulted; however, institutions should assess whether the default of the joint credit obligation at hand constitutes an indication of unlikeliness to pay with regard to the other joint credit obligations.

84. Where the conditions of points (a) or (b) or both of Article 178(1) of Regulation (EU) No 575/2013 are met with regard to the credit obligation of an individual obligor, the contagious effect of this default should not automatically spread to any joint credit obligations of that obligor; nevertheless, institutions should assess such joint credit obligations for possible indications of unlikeliness to pay related with the default of one of the obligors. In any case, where all individual obligors have a defaulted status, their joint credit obligation should automatically also be considered defaulted.

85. Institutions should identify, on the basis of the analysis of relevant legal provisions in a jurisdiction, and provide in their internal policies and procedures for the identification of the obligors that are legally fully liable for certain obligations jointly and severally with other obligors, therefore being fully liable for the entire amount of those obligations, but excluding credit obligations of an individual obligor secured by another individual or entity in the form of a guarantee or other credit protection. A typical example would be a married couple where, based on specific legal provisions applicable in the relevant jurisdiction, division of marital property (system of separate estates) does not apply. In the case of full mutual liability for all obligations, default of one of such obligors should be considered an indication of potential unlikeliness to pay of the other obligor and therefore institutions should assess whether the individual and joint credit obligations of these obligors should be considered defaulted. Where one of the joint and several obligors that are legally fully liable for all obligations, has a joint credit obligation with another client, the institution should assess whether indications of unlikeliness to pay occur also on the other joint credit obligations with third parties.

86. Institutions should also analyse the forms of legal entities in relevant jurisdictions and the extent of liability of the owners, partners, shareholders or managers for the obligations of a company depending on the legal form of the entity. Where an individual is fully liable for the obligations of a company, default of that company should result in that individual being considered defaulted as well. Where such full liability for the obligations of a company does not exist, owners, partners or significant shareholders of a defaulted company should be assessed by the institution for possible indications of unlikeliness to pay with regard to their individual obligations.

87. Additionally, in the specific case of an individual entrepreneur where an individual is fully liable for both private and commercial obligations with both private and commercial assets the default of any of the private or commercial obligations should cause all private and commercial obligations of such individual to be considered as defaulted as well.

88. Where the definition of default is applied at the level of an obligor for retail exposures, the materiality threshold should also be applied at the level of an obligor. Institutions should clearly specify in their internal policies and procedures the treatment of joint credit obligations in the application of the materiality threshold.

89. A joint obligor, i.e. a specific set of individual obligors that have a joint obligation towards an institution, should be treated as a different obligor from each of the individual obligors. In the case the delay in payment occurs on a joint credit obligation, the materiality of such delay should be assessed by applying the materiality threshold referred to in point (d) of Article 178(2) of Regulation (EU) No 575/2013 to all joint credit obligations granted to this specific set of obligors. For this purpose the individual exposures to obligors participating in a joint credit obligation or to any other subsets of such obligors should not be taken into account. However, where the materiality threshold for a joint obligor calculated in this way is breached, all joint credit obligations of this set of obligors and all individual exposures to the

obligors participating in a joint credit obligation should be considered defaulted in line with paragraph 83.

90. When delay in payment occurs on an individual credit obligation, the materiality of such delay should be assessed by applying the materiality threshold referred to in point (d) of Article 178(2) of Regulation (EU) No 575/2013 to all individual credit obligations of this obligor, without taking into account any joint credit obligations of that obligor with other individuals or entities. Where the materiality threshold calculated in this way is breached, all individual exposures to this obligor should be considered defaulted.

Explanatory text for consultation purposes

The proposed approach with regard to the application of materiality threshold for joint credit obligations seems to offer a solution that is simple, easy to implement and at the same time ensures that the objectives are met.

An alternative solution that has been considered assumed aggregation of individual and joint credit obligations. According to this alternative solution, in the case the delay in payment occurs on any individual or joint credit obligation, the materiality of such delay should be assessed by applying the materiality threshold at an aggregate level for all joint credit obligations granted to this set of obligors and all their individual credit obligations. If a materiality threshold calculated in this way is breached all joint credit obligations of this set of obligors should be considered defaulted.

At the same time, for the purpose of assessment of the materiality of delay in payment of an individual obligor, the materiality threshold would be applied at an aggregate level for all individual credit obligations of that obligor and all joint credit obligations of that obligor with other individuals or entities. If a materiality threshold calculated in this way is breached all individual exposures to this obligor should be considered defaulted.

Nevertheless the solution proposed in the draft guidelines seems simpler and more straightforward than the alternative described above. Also, as it takes into account only relevant exposures, it does not lead to the dilution of the relative materiality threshold.

Question 10: Do you agree with the approach proposed for the application of materiality threshold to joint credit obligations?

10. Documentation, internal policies and risk management processes

Timeliness of the identification of default

91. Institutions should have effective processes that allow them to obtain the relevant information in order to identify defaults in a timely manner, and to channel the relevant

information in the shortest possible time and, where possible, in an automated manner, to the personnel that is responsible for taking credit decisions, and more in particular:

(a) where they apply automatic processes, such as counting of days past due, the identification of indications of default should be performed on a daily basis;

(b) where they implement manual processes, such as checking external sources and databases, analysis of watch lists, analysis of the lists of forborne exposures, identification of SCRA, the information should be updated with a frequency that guarantees the timely identification of default.

92. Institutions should verify on a regular basis that all forborne non-performing exposures are classified as default and subject to distressed restructuring. Institutions should also analyse on a regular basis the forborne performing exposures in order to determine whether any of them fulfils the indication of unlikeliness to pay as specified in Article 178(3)(d) of Regulation (EU) No 575/2013 and in paragraphs 38 to 44.

93. Control mechanisms should ensure that the relevant information is used in the default identification process immediately after being obtained. All exposures to a defaulted obligor or all relevant exposures in case of the application of the definition of default at the facility level for retail exposures should be marked as defaulted in all relevant IT systems without undue delay. If delays occur in the recording of the default, such delays should not lead to errors or inconsistencies in risk management, risk reporting, the own funds requirements calculation or the use of data in risk quantification. In particular it should be ensured that the internal and external reporting figures reflect a situation where all exposures are correctly classified.

Documentation

94. Institutions should document their policies regarding the definition of default including all triggers for identification of default and the exit criteria as well as clear identification of the scope of application of the definition of default and, more in particular they should:

(a) document the operationalisation of all indications of default;

(b) document the operationalisation of the criteria for reclassification of a defaulted obligor to a non-defaulted status;

(c) keep an updated register of all definitions of default.

95. For the purposes of point (a) of paragraph 94, institutions should document the application of the definition of default in a detailed manner by including the operationalization of all indications of default, including the process, sources of information and responsibilities for the identification of particular indications of default.

96. For the purposes of point (b) of paragraph 94, institutions should document the operationalization of the criteria for reclassification of a defaulted obligor to a non-defaulted status, including the processes, sources of information and responsibilities assigned to relevant personnel.

97. For the purposes of paragraphs 95 and 96, the documentation should include description of all automatic mechanisms and manual processes, and where qualitative indications of default or criteria for the return to non-defaulted status are applied manually the description should be sufficiently detailed to facilitate common understanding and consistent application by all responsible personnel.

98. For the purposes of point (c) of paragraph 94, institutions should keep an updated register of all current and past versions of the default definition at least starting from the date of application of these guidelines. This register should include at least the following information:

    (a) the scope of application of the default definition, if there is more than one default definition used within the institution, the parent undertaking or any of its subsidiaries;

    (b) the body approving the definition or definitions of default and date of approval for each of those definitions of default;

    (c) the date of implementation of each definition of default;

    (d) brief description of all changes performed relatively to the last version;

    (e) in the case of institutions that have permission to use the IRB Approach, the change category assigned, the date of submission to the competent authorities and, if applicable, the date of approval by the competent authorities.

Internal governance requirements for institutions applying the IRB Approach

99. Institutions that use the IRB Approach should adopt adequate mechanisms and procedures in order to ensure that the definition of default is implemented and used in a correct manner, and should in particular ensure that:

    (a) the definition of default and the scope of its application is what is required to be approved by the management body, or by a committee designated by it, and by senior management in accordance with Article 189(1) of Regulation (EU) 575/2013;

    (b) the definition of default is used consistently for the purpose of the own funds requirements calculation and plays a meaningful role in the internal risk management processes by being used at least in the area of monitoring of exposures and in the internal reporting to senior management and management body;

(c) the internal audit unit or another comparable independent auditing unit reviews regularly the robustness and effectiveness of the process used by the institution for the identification of default, taking into account in particular the timeliness of the identification of default referred to in paragraphs 91 to 93; and ensuring that the conclusions of the internal audit's review and respective recommendations, as well as the measures taken to remedy the identified weaknesses are communicated directly to the management body or the committee designated by it.

Explanatory text for consultation purposes

The requirements regarding internal governance have been introduced only for the institutions that use the IRB Approach, because only for the IRB Approach there is a legal basis already existing in the CRR:

- Article 189 for involvement of the management body;
- Article 144 for use test;
- Article 191 for internal audit.

In the case of institutions that use the Standardised Approach it is possible that the definition of default used for internal risk management differs from the definition used for the purpose of own funds requirements calculation. It is also not required that the rules for segmentation of exposures into exposure classes are approved by the management body or a committee designated thereof therefore it does not seem necessary to introduce that rule specifically for the definition of default that is used for the purpose of classification to one of the exposure classes. Furthermore, there are no specific requirements with regard to control functions. In particular, internal audit function has full flexibility in assessment of the level of risk related with particular processes at the institution and specifying the frequency of reviews.

An alternative approach could be to introduce the proportionality principle in the application of the internal governance requirements by the banks that use the Standardised Approach.

Question 11: Do you agree with the requirements on internal governance for banks that use the IRB Approach?

5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

A. Problem identification

Under Article 178(7) of Regulation (EU) No 575/2013, the EBA is required to develop guidelines on the application of the definition of default.

The primary problem that the guidelines aim to address is the potential lack of common practice and variations in the application of the definition of default. Significant variations have been observed in particular in such areas as counting of days past due, assessment of indications of unlikeliness to pay, criteria for reclassification of an obligor from default to non-defaulted status and the use of technical defaults. Lack of common and consistent application of the definition of default may further lead to incomparability of IRB risk parameters and own funds requirements both under the IRB and the Standardised Approach. This situation creates uneven playing field across Member States and institutions.

B. Policy objectives

The objective of the guidelines is to establish convergence of institutions' and supervisory practices regarding the application of the definition of default. The guidelines are complementary to the recently prepared RTS on the materiality threshold past due (EBA/CP/2014/32) and issue indications and criteria for the application of definition of default. Harmonisation of the current practices that vary across Member States and institutions is expected to enhance comparability of own funds and own funds requirements and to reduce the burden for cross-border institutions to comply with different regulatory frameworks.

The guidelines aim to set common criteria in the major policy fields including:

- past due criterion as an indication of default,
- indications for unlikeliness to pay,
- the return to non-defaulted status, and
- the application of the definition of default for retail exposures,
- the application of the definition of default in external data.

C. Baseline scenario

EBA carried out a survey among competent authorities in June 2013 to collect information on supervisory practices in various areas including the application of the definition of default. A total of 21 Member States participated in the survey and the basis of the baseline scenario is the responses to these surveys together with additional inputs from the members of the Task Force on Model Validation. The survey provides a limited amount of input for the assessment of the baseline scenario. Only 13 out of 21 Member States that participated in the survey admitted to have any national rules concerning default and past due definition. Most of these rules are related with the materiality threshold for past due exposures, this aspect however is excluded from the analysis in this impact assessment as it will be specified in the RTS on the materiality threshold for past due exposures and therefore is not in the scope of the GL on default of an obligor. Only seven Member States have rules to determine unlikeliness to pay that trigger the default status.

Available information from the supervisors and from occasional meetings with the industry shows that there are great variations across Member States and institutions in the application of the definition of default. These conclusions have also been confirmed in the IIF Risk-Weighted Assets Task Force report issued in November 2014 and distributed among supervisory authorities.

The baseline information is the benchmark to assess the potential costs and benefits that the Member States will be subject to under the technical options. In other words, if the current practices in the Member States are the same as or similar to the elements that are considered in the current guidelines, the expected costs and benefits are smaller than when the current practice is very different than the final policy decision taken under the guidelines.

D. Options considered

Current section presents the assessment of the technical options considered in the guidelines. Under each option, the potential advantages and disadvantages of the options together with potential costs and benefits are discussed.

a. Treatment of retail exposures

Institutions should choose the level of application of the definition of default for retail exposures so that it reflects their internal risk management practices. In exceptional situations institutions may be allowed to apply the definition of default at the level of an obligor for some types of retail exposures and at the level of a credit facility for others.

The guidelines require that in the case an institution decides to use different levels of application of the definition of default for the different types of retail exposures it should provide evidence that the scope of application of each definition of default is clearly specified. In addition to this, the guidelines considered:

a. Requirement to use the same level of application across all retail portfolios of the institution, parent undertaking and any of its subsidiaries,
b. Possibility to use different levels of application of the definition of default for certain retail portfolios only in the case where there are no or limited number of common clients between those portfolios, and

c. Possibility to use different levels of application of the definition of default for certain retail portfolios if this is justified by different internal risk management practices.

Option a achieves full and strict harmonisation across Member States and adherence to CRR requirements. It also provides full comparability of default rates between portfolios. However, the option suffers from the lack of flexibility; it is not possible to adjust the level of application of the definition of default to internal risk management practices.

Option c provides institutions full flexibility to adjust the level of application of the definition of default to internal risk management practices however it may lead to lack of adherence to CRR requirements as regards the application of the definition of default at the obligor level. It is possible that one exposure of the obligor that is assessed at the facility level is defaulted whereas other exposures remain in the non-defaulted status even though the definition of default applies at the obligor level. Additionally this does not allow comparability of default rates between portfolios.

Option b finds a balance between the two previous options. While it creates common playing field for the institutions and the regulators, it also provides flexibility to adjust the level of application of the definition of default to internal risk management practices, especially for entities located in different jurisdictions. At the same time it ensures compliance with the CRR that where definition of default is applied at the obligor level all exposures of an obligor are defaulted at the same time. Under option b the cost is expected to incur due to routine monitoring of the number of common clients between portfolios. However, the costs are expected to exceed the benefits. The preferred option is option b.

b. Treatment of pulling effect

Where the institution decides to apply the definition of default at the level of an individual credit facility there is no automatic contagion between exposures. Nevertheless some indications of default are related with the condition of an obligor rather than the status of a particular exposure.

The so called 'pulling effect', introduced in the ITS on supervisory reporting, is related with the threshold in terms of a percentage of total credit obligations of an obligor that indicates when all exposures of an obligor should be considered non-performing. This means that for the purpose of supervisory reporting if 20% of exposures of one obligor are classified as non-performing all other exposures to this obligor should also be reported as non-performing.

As all defaulted exposures are required to be reported as non-performing the pulling effect is in practice only applicable to retail exposures where the definition of default is applied at the facility level. In all other cases, i.e. where the definition of default is applied at the obligor level, if one exposure is considered defaulted then all other exposures also have to be classified as defaulted and therefore all exposures of an obligor are classified as non-performing.

The current qualitative analysis assesses whether the guidelines should introduce requirements related to pulling effect in the application of the definition of default. The options include:

a. No pulling effect for prudential purposes;
b. The threshold for pulling effect to be specified by the institution;
c. The threshold for pulling effect to be specified by the institutions with a cap at 20%;
d. The threshold for pulling effect to be specified at the level of 20%.

Option a suggests no pulling effect provision in the guidelines. A major advantage of the option is that the possible contagion of default between exposures of an obligor may be implemented fully in line with the internal risk management procedures however the option is not in line with the ITS on Supervisory Reporting and might lead to decreased comparability of risk estimates among institutions.

Option b suggests the institutions to specify the threshold for pulling effect. In this way, institutions may be able to set the thresholds at the optimum level given their risk management systems. Major disadvantages of this option is still the lack of harmonization and possible divergence from the ITS on Supervisory Reporting.

Option c elaborates on the previous option and sets a cap of 20% in line with the ITS on Supervisory Reporting. Under this option institutions will specify the threshold for pulling effect but these thresholds will be capped at 20%. If an institution decides to introduce lower threshold, all defaulted exposures will be reported as non-performing. Also, the option gives the possibility to introduce stricter rules if this is justified by the observed historical data. A concern related with this option is that the cap may lead to excessive number of zero-loss defaults.

Option d sets the threshold for pulling effect at the 20% level. Although the option achieves full harmonization and alignment with supervisory framework, it lacks flexibility and has room for excessive number of zero-loss defaults.

Taking into account the considerations related with the recognition of zero-loss defaults and possible future changes in the supervisory reporting framework it is proposed that pulling effect should not be introduced as an obligatory requirement for the purpose of definition of default in the prudential framework, therefore the preferred option is option a. Nevertheless, some institutions might still see this as an indication of unlikeliness to pay of the remaining exposures of this obligor and might want to align the treatment of exposures for prudential and reporting purposes. Therefore it is proposed that where institutions consider it appropriate they may define an additional indication of unlikeliness to pay that will reflect the principal of pulling effect.

c. Definition of technical default

The concept of so called 'technical defaults' has not been specified in the CRR. However, this notion is commonly used across banks although its meaning and application varies significantly. When specifying the draft RTS on the materiality of past due exposures technical default was understood as a situation where small amounts are past due as a result of technical circumstances rather than the financial situation of the obligor. The main purpose of the RTS on materiality threshold for past due exposures will be to identify such situations and eliminate them from the estimation of risk parameters. Since the materiality threshold already serves the role of identification of technical delays in payments all exposures where the materiality threshold has been breached should be treated as actual defaults.

Current qualitative analysis assesses whether the guidelines should introduce a precise definition of technical default in order to ensure harmonized application of the definition of default. The assessment includes the following options:

a. No definition of technical defaults;
b. Technical default referring to various not-credit related reasons for the delays in payments;
c. Technical default specified as a situation where the default event has not really occurred but default identification was a result of certain errors or inefficiencies in data, IT systems or processes;
d. Technical default specified as exposures past due where the materiality threshold has not been breached.

It might be argued that it is obvious that all exposures past due where the materiality threshold has been breached should be treated as defaulted because that is required directly by the CRR and the CRR does not envisage any exceptions from this rule. However, as many various practices are currently observed, not including a provision on the definition of technical default (option a) would sanction the status quo and leave room for various supervisory expectations. As a result the policy would not achieve harmonisation in the treatment of defaults in the risk parameters estimation.

Option b allows the possibility to account for specific situation of each obligor, i.e. not-credit related reasons for the delays in payments assuming that it would be possible to define these situations in a precise and accurate manner. However, this option may overlook the actual defaults and does not achieve full compliance with the CRR requirements. Also in this option the harmonisation of approached would not be achieved as the assessment of non-credit related situations would involve subjective judgment and could in some cases be overused leading to underestimation of risk parameters.

Option c defines technical default as a situation where the default event has not really occurred. The option clearly defines the limits of the technical default. It is a simple and unambiguous definition that allows harmonized implementation. It also allows full compliance with the CRR requirements although defaults may include cases where delay in payments result from non-credit risk related events.

Finally option d suggests that technical default could be defined as exposures past due where the materiality threshold has not been breached. This is also a simple and unambiguous definition that allows harmonized implementation however under this option bank errors on amounts exceeding the materiality threshold would count as defaults and therefore the estimates could give inaccurate and wrong information. Additionally, some of these situations may in fact result from credit risk related reasons, therefore this definition would not be sufficiently precise. Delay in payment over the materiality threshold should only be treated as a backstop, i.e. latest possible moment for the identification of default.

Taking into account the above considerations option c seems to be the most appropriate.

d. Alignment with supervisory reporting framework

The supervisory reporting framework and in particular the ITS on non-performing exposures and forbearance defines these concepts that are related with the quality of assets and obligors. As the industry has requested on several occasions to align supervisory reporting with the prudential framework this was taken into consideration in the specification of these guidelines. The following main options were considered:

a. Alignment of the definition of default with the non-performing exposures;
b. Alignment of the definition of default with the non-performing exposures with the exception for the use of 180 days past due instead of 90;
c. Non-obligatory alignment of the definition of default with the non-performing exposures;
d. No alignment, non-performing exposures remain a broader category than defaulted exposures.

According to the definition included in the above mentioned ITS the category of non-performing exposures includes all defaulted exposures but may also include other exposures that are not treated as defaulted. Therefore full alignment could be achieved by specifying that all non-performing exposures should be treated as defaulted (option a). However, this rule might lead to unintended consequences and excessively high default rate and cure rate. In particular, in the case institutions are allowed to use 180 days past due instead of 90 in accordance with Article 178(1)(b) of Regulation (EU) No 575/2013, this discretion would in practice be overruled by the alignment with supervisory reporting framework where such discretion does not exist.

Option b tackles this problem by specifying an exemption. Still large degree of alignment would be achieved, the source of differences would be clear and unambiguous and would only apply to some institutions in the jurisdictions that decided to exercise the discretion specified in Article 178(1)(b) of Regulation (EU) No 575/2013.

Nevertheless option b might still lead to higher default rate, the impact would be significantly different for different institutions. For this reason also option c was taken into consideration. Under this option institutions would be able to choose whether it is appropriate in their situation to align the definitions. The way to achieve this alignment would be specified in the guidelines.

Under option d the status quo would remain with the majority of institutions not having the definitions aligned and uncertainty regarding the relations between prudential and reporting frameworks.

Given the qualitative assessment of the options, the preferred option is option c.

e. Materiality threshold for the sale of credit obligations

Where the institution sells the credit obligations due to the decrease in their quality or the loss on that sale is otherwise related with the credit quality of the obligations, the institution should analyse the materiality of the economic loss. If the economic loss is material this should be considered an indication of default. The assessment looks at the following options:

a. No materiality threshold for the economic loss related with the sale of credit obligations;
b. Materiality threshold for the economic loss defined as the difference between the outstanding amounts of the obligations with the agreed sale price;
c. Materiality threshold for the economic loss defined as the difference between the outstanding amounts of the obligations with the agreed sale price, subject to a cap;
d. Materiality threshold for the economic loss defined by the institutions.

Not to introduce a materiality threshold is a conservative approach in the recognition of defaults. However the major weaknesses of option a is that the treatment of all sales of credit obligations with a loss as defaults, even if the loss is close to zero, would underestimate the loss given default and similarly, it will overestimate the probability of default as the occurrence of the defaults identified increases.

Option b proposes to calculate the materiality of the overall economic loss related with the sale of exposures as the difference between the outstanding amounts of the obligations and the agreed sale price. Institutions are entitled to set a threshold in terms of percentage of this difference to the outstanding amounts of the sold obligations. If the difference is higher than the threshold as specified by the institution the exposures should be considered defaulted.

The advantages of this option are that it establishes a harmonized approach with regard to the way the sales of credit obligations are assessed. On the other hand, a major disadvantage of the option is the possibility of setting a wide range of thresholds by institutions and in some cases non-recognition of defaults even if the loss seems material. As a result it would not lead to increased comparability of risk estimates.

Option c suggests the same calculation as described under option b with and addition of a 5% cap. The threshold set by the institutions should not be higher than 5%. The option somewhat inherits the advantages of the option b but also enhances comparability of default rates and capital requirements across institutions and Member States by significantly reducing the possible range of thresholds. However, if the threshold is set too low there may be the overestimation of probability of default and the underestimation of loss given default (as described also under option a).

Finally, option d leaves the materiality threshold for the economic loss to be set by the institutions. The option is fully flexible as it gives the institutions the room to align with internal risk management and perceived materiality of economic loss. However, the option fails to establish a harmonized regulatory framework, may lead to not risk-based differences in the risk estimates and underestimation of capital requirements.

Given the qualitative assessment of the options, the preferred option is option c.

f. Materiality threshold for distressed restructuring

The obligor should be considered defaulted when the distressed restructuring is likely to result in a diminished financial obligation. Distressed restructuring has been defined similarly as forbearance therefore those forborne exposures, where the forbearance measures are likely to result in a diminished financial obligation should be classified as defaulted.

The policy options discuss if the guidelines should introduce materiality threshold for distressed restructuring for the scale at which the financial obligation is diminished and if they do then in what form this threshold should be specified. For this, the following options have been considered:

a. No materiality threshold for the diminished financial obligation;
b. Materiality threshold for the diminished financial obligation specified by institutions as the difference between the present value of expected cash flows before and after changes in terms and conditions of the contract;
c. Materiality threshold for the diminished financial obligation specified by institutions as the difference between the present value of expected cash flows before and after changes in terms and conditions of the contract, subject to a cap;
d. Materiality threshold for the diminished financial obligation to be specified by institutions.

The reasoning for the assessment of the policy options in this field is very similar to the one presented under the options related the sale of credit obligations. Here, the preferred option is option c. In order to assess whether the restructuring arrangements lead to diminished financial obligation institutions should compare the present value of expected cash flows before the changes in terms and conditions of the contract and present value of the expected cash flows based on the new arrangement, both discounted using the original effective interest rate and assess whether the difference between them is material. Institutions should set a threshold in terms of percentage of such difference to the present value of expected cash flows before the application of restructuring arrangements. If the difference is higher than the threshold as specified by the institution the exposures should be considered defaulted.

It is proposed that the threshold set by the institutions should not be higher than 1%. The proposed cap in this situation is lower because it is meant to capture the cases where the change in NPV of the contract results from technical discounting aspects and rounding of the amounts. Where however the diminished NPV results from the conscious decision of an institutions due to the clients' financial difficulties these situations should be treated as defaults.

g. Probation period for the return to non-defaulted status

Institution should define clear criteria when it can be considered that the improvement of the financial situation of an obligor is sufficient to allow the full and timely repayment of the credit obligation and that it is no longer unlikely that the repayment will actually be made. The current analysis considered several options for the period to assess the financial situation of an obligor for this purpose. These options related to the probation period are:

a. No probation period, return to non-default immediately after no material obligation is past due more than 90 days;
b. No probation period, return to non-default immediately after there are no amounts past due;
c. Minimum probation period specified by the institutions;
d. Minimum probation period specified by the institutions with a minimum duration of three months from the moment that no specific indications of default apply.

Both options a and b may lead to excessive number of multiple defaults. Under option b this problem is to some extent mitigated as the further delays in payment would result in the recognition of next default only after 3 months from the return to non-defaulted status. However, in the case of rare payments the return to non-defaulted status would only be temporary and multiple defaults would still be recognised.

Option c helps institutions align the probationary requirements with internal risk management practices and avoids excessive number of multiple defaults. However, this option fails to establish a harmonised approach across Member States. Under this approach variations across jurisdictions are expected to prevail both in terms of the length and the starting moment of the probation periods.

Option d develops option c with an additional minimum requirement of three months and specification of the starting point. Only after that period institutions may consider that the condition specified in Article 178(1)(a) of Regulation (EU) No 575/2013 no longer continues to apply. In this assessment institutions should take into account the behaviour of the obligor during the probation period and financial situation of the obligor. If after the probation period institution still assesses that the obligation is unlikely to be paid in full without recourse to realising security, the exposures should continue to be classified as defaulted until the institution is satisfied that the improvement of the credit quality is factual and permanent.

Option d is a prudent approach and avoids frequent changes of status of exposures and thus excessive number of multiple defaults. Since it strikes a balance between harmonisation and flexibility it is selected to be the preferred option.

h. Probation period and other conditions for distressed restructuring

The current assessment is similar to the previous analysis and looks at the probation period together with other conditions for when distressed restructuring may return to non-defaulted status, including:

a. Distressed restructuring treated the same as other indications of unlikeliness to pay;
b. Extended probation period for distressed restructuring to be specified by the institutions;

c. Extended probation period of at least one year for distressed restructuring specified in the current guidelines;
d. Return to non-default possible only after full repayment of the contract subject to distressed restructuring.

Option a is operationally simple however it can identify excessive number of multiple defaults and does not account for specific risk related with distressed restructuring. The option is also not aligned with supervisory reporting.

Option b suggests that the institutions specify the extended probation period for distressed restructuring. This option allows the alignment with internal risk management practices of the institutions and would probably in many cases avoid excessive number of multiple defaults. However, it does not achieve the objective of harmonisation. Variations in non-risk based differences in the risk estimates may prevail.

Option c suggests an extended period of at least one year under the conditions specified in the guidelines. This is considered to be prudent approach and expected to avoid excessive number of multiple defaults. It also aligns with supervisory reporting although in some cases it may be perceived as excessively conservative.

Finally, option d, although relatively easy to implement, seems to include excessive conservatism especially in the case of long term restructuring contracts.

Taking into account the presented argumentation preferred option is option c.

i. Frequency of counting of days past due

Counting of days past due and the identification of indications of default on a timely and effective manner is essential for an adequate application of the default definition. In this field, two options have been considered:

a. Not specifying the frequency on counting days past due and;
b. Introducing requirement to count days past due on a daily basis.

Option a will not generate implementation cost however it is not adequate to reach the objectives of harmonisation and common standards. Under this option the baseline scenario is expected to remain the same, i.e. variation across jurisdictions in the application of the definition of default and the regulation then may not be able to identify risk-based differences in the estimates.

Option b introduces a requirement to count days past due on a daily basis. The option aims to make available on-time information on the event of default in the internal risk management processes. This option may require modifications of IT systems in some banks therefore will generate further costs to the institutions that are currently applying this rule on a less frequent basis.

Since the option b achieves the objectives of common standards and creates a more prudential regulatory framework with small operational cost, it is selected as the preferred option.

In overall, given the advantages and the disadvantages of the policy options the assessment aimed to achieve most optimal set of options so that a balance between harmonisation and common set of rules on the one hand and some flexibility to accommodate differences between institutions on the other hand. The preferred options tried to achieve a definition of default such that the regulatory framework is prudent and in line with the CRR, that the regulatory criteria do not lead to excessive number of defaults and allow alignment with internal risk management of the institution.

E. Cost-Benefit Analysis

Under the Standardised Approach, Article 127 of Regulation (EU) No 575/2013 groups the unsecured parts of defaulted exposures as a specific asset class. Within this asset class the risk weight is assigned according to the ratio between the unsecured part of the exposure value and specific credit risk adjustments. If the specific credit risk adjustments are equal to or greater than 20% of the unsecured part of the exposure value then the assigned risk weight is 100%. The assigned risk weight is 150% if the specific credit risk adjustments are less than 20% of the unsecured part of the exposure value. In other words, stricter default definition might lead to higher level of defaulted exposures in the asset class where higher risk weights are assigned.

Under the IRB approach the definition of default has an impact on the classification of exposures as defaulted with the probability of default (PD) that is equal to 100%, which therefore has an impact on the calculation of expected loss (EL) and own funds requirements that represent the unexpected loss. For the Foundation IRB approach (FIRB) the risk weight of defaulted exposure is set to zero. However the calculation of expected loss is based on PD that is equal to 100%, therefore it is much higher than if the exposure was not classified as defaulted. If the expected loss is not fully covered by the credit risk adjustments then the difference is deducted from own funds. For the Advanced IRB (AIRB) approach the logic is the same except that the risk weight for defaulted exposure is not zero but is calculated on the basis of the loss given default (LGD) parameter.

In addition, the default definition influences the own funds requirements of the IRB institutions through the estimation of PD, LGD and conversion factors parameters. Risk weights for non-defaulted exposures are calculated according to a standard formula based on the risk parameters.

Stricter default definition would result in relatively higher default rate and PD estimates. However, not all of the identified defaults generate losses so this could decrease the LGD estimates of the AIRB institutions.

Taking into account these considerations and complex manner in which default definition influences own funds and own funds requirements it is difficult at this point to assess the impact of the guidelines on EL and capital requirements of the institutions. Furthermore, various technical options may have different impact on the default rates on various institutions and it is not clear at this point whether in overall these guidelines will lead to increase or decrease of defaulted exposures. Therefore the current assessment is high level and qualitative in nature and EBA will carry out a more elaborated QIS on the subject. The QIS will aim to analyse in quantitative manner the impact of the selected technical options on the relevant risk parameters, capital requirements and expected loss. Furthermore, qualitative information will be gathered on the current practices in order to analyse the potential scope of necessary changes. Additionally, it is planned to assess the impact of these guidelines on the capital requirement of institutions that use the Standardised Approach.

a. Costs for institutions

Currently the institutions already use certain definitions of default. In the absence of detailed guidance institutions adopted various approaches with regard to the application of the definition of default defined in the CRR. As a result, with the adoption of these guidelines some institutions will have to introduce some changes. These changes might have significant impact on the operations of the institutions. The impact and costs for particular institutions will depend on the currently implemented choices as well as the approach used in the calculation of own funds requirements.

Any changes in default definition will affect in particular those institutions that use the IRB approach. The risk parameters are estimated on the basis of historical data collected with certain default identification processes. The consistency of the historical data with the default definition is crucial for the correct calibration of risk parameters. The historical data will therefore have to be adjusted to the requirements of the guidelines and the parameters will have to be recalibrated to reflect the current default definition.

The adjustment of data and recalibration of risk parameters may impose a significant operational burden on the banks that use the IRB approach. In particular for those institutions that use numerous rating systems and where the definition of default will change significantly, the process of implementing necessary adjustments might be costly and time consuming.

In the case of institutions that use the Standardised Approach the impact of the changes will be relatively less significant as there will be no need to adjust historical data unless the institution will decide to apply for IRB approach in the future. Nevertheless in the case of those institutions for which the default definition will change significantly the costs might still be material as it might require the change in the current processes and possibly also IT systems used to collect the data and calculate capital requirements.

b. Costs for national supervisory authorities

According to the RTS on the materiality of changes and extensions of the advanced approaches any change in the definition of default is a material change that requires approval of a competent authority. Therefore the impact for the national supervisory authorities will come with the applications from the institutions that were granted permission to use the IRB approach for material changes of rating systems related with the change of default definition. Granting such approvals in a timely manner might cause significant operational burden for the national supervisors.

c. Benefits

Default definition is the basis for all risk parameters estimated according to IRB models and for the calculation of own funds requirements. Therefore, by establishing harmonised criteria for the application of the definition of default greater comparability of risk estimates and own funds requirements for credit risk will be ensured. By aligning also the supervisory expectations in that regard the level playing field for the institutions will be enhanced. Finally, similar practices applied in all jurisdictions will also reduce the administrative and operational burden for cross-border institutions to comply with different regulatory frameworks in different Member States.

5.2 Overview of questions for consultation

1. Do you agree with the proposed definition of technical defaults? Do you believe that other situations should be included in this definition? If yes, please provide detailed proposals on how to address further possible situations.

2. Do you consider the requirements on the treatment of factoring arrangements as appropriate and sufficiently clear? If not, please provide proposals for additional clarifications.

3. Do you agree with the approach proposed for the treatment of specific credit risk adjustments?

4. Do you consider the proposed treatment of the sale of credit obligations appropriate for the purpose of identification of default?

5. Do you agree that expected cash flows before and after distressed restructuring should be discounted with the customer's original effective interest rate or would you prefer to use the effective interest rate applicable at the moment before signing the restructuring arrangement? Do you consider the specification of the interest rate used for discounting of cash flows sufficiently clear?

6. Do you agree that the purchase or origination of a financial asset at a material discount should be treated as an indication of unlikeliness to pay?

7. What probation periods before the return from default to non-defaulted status would you consider appropriate for different exposure classes and for distressed restructuring and all other indications of default?

8. Do you agree with the proposed approach as regards the level of application of the definition of default for retail exposures?

9. Do you consider that where the obligor is defaulted on a significant part of its exposures this indicates the unlikeliness to pay of the remaining credit obligations of this obligor?

10. Do you agree with the approach proposed for the application of materiality threshold to joint credit obligations?

11. Do you agree with the requirements on internal governance for banks that use the IRB Approach?