



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP17/18

Credit risk: the definition of default

July 2018



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Responses are requested by Monday 29 October 2018.

Please address any comments or enquiries to:

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1 Overview

1.1 In this Consultation Paper (CP), the Prudential Regulation Authority (PRA) sets out its proposed approach to implementing the European Banking Authority's (EBA's) recent regulatory products relating to the definition of default in the Capital Requirements Regulation (575/2013) (CRR).¹

1.2 The PRA proposes to update the PRA's expectations in Supervisory Statement (SS) 11/13 'Internal Ratings Based (IRB) approaches' to implement the EBA's regulatory products that relate to the definition of default (see Appendix 1). The PRA also proposes to amend the Credit Risk Part of the PRA Rulebook to set thresholds for determining whether a credit obligation is material for the purpose of the CRR's definition of default (see Appendix 2).

1.3 The proposals are relevant to UK banks, building societies and PRA-designated UK investment firms.

Background

1.4 The EBA has developed a roadmap of regulatory products ('EBA roadmap') with the aim of reducing unwarranted variability in the risk weighted assets (RWAs) calculated using banks' IRB models.²

1.5 Two of the products from the EBA roadmap relate to the definition of default: the Regulatory Technical Standards ('the RTS') for the materiality threshold for credit obligations past due³ and the Guidelines on the application of the definition of default ('the GL').⁴ The PRA informed the EBA that it intends to comply with the GL from 31 December 2020. The EBA has also published a third product on the definition of default: an EBA Opinion on the use of the 180 days past due criterion in the days past due component of the definition of default ('the EBA Opinion').⁵

1.6 This CP sets out the PRA's proposed approach to implementing these three products.

1.7 The proposals in this CP relating to the RTS and GL apply to firms using the standardised approach ('SA firms') and firms using the IRB approach ('IRB firms') for calculating capital requirements for credit risk.⁶ The proposals relating to the EBA Opinion apply to IRB firms only.

1.8 The PRA also intends to publish a second CP on the PRA's proposed implementation of the remaining aspects of the EBA roadmap: the Guidelines on probability of default (PD) estimation, loss given default (LGD) estimation and the treatment of defaulted exposures; and the RTS that specifies the nature, severity and duration of an economic downturn. The second CP will be published after the EBA has finalised the relevant regulatory products.

Purpose

1.9 CRR Article 178 sets out the following definition of default, which includes two triggers:

1 CRR Article 178.

2 www.eba.europa.eu/-/eba-sets-out-roadmap-for-the-implementation-of-the-regulatory-review-of-internal-models

3 http://data.europa.eu/eli/reg_del/2018/171/oj

4 www.eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-the-application-of-the-definition-of-default

5 www.eba.europa.eu/-/eba-advises-the-commission-to-disallow-the-application-of-the-180-day-past-due-exemption-for-material-exposures

6 CRR Articles 127 and 178.

- (i) the first defines the ‘unlikelihood to pay’ criterion. CRR Article 178(1)(a) states that ‘an institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security’; and
- (ii) the second defines the ‘days past due’ criterion. CRR Article 178(1)(b) states that ‘the obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries. Component authorities may replace the 90 days with 180 days for exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to public sector entities. The 180 days shall not apply for the purposes of Article 127.’

1.10 The purpose of the proposed PRA rule is to set a threshold against which the materiality of a credit obligation past due shall be assessed (the ‘materiality threshold’) for the days past due criterion of the definition of default.¹ As required by the CRR and the RTS, the PRA is proposing to set materiality thresholds that it considers reflect a reasonable level of risk for retail and non-retail exposures.

1.11 The purpose of the proposed updates to SS11/13 is to set out the PRA’s expectations relating to the GL and EBA Opinion. The PRA proposes to expect firms to comply with the GL and to remove the use of 180 days past due, and use 90 days past due instead, in the ‘days past due’ component of the definition of default for all exposure classes.

Summary of proposals

1.12 The policy proposals contained in this CP are to:

- (i) set a 0% relative materiality threshold and zero absolute materiality threshold for retail exposures;
- (ii) set a 1% relative materiality threshold and a sterling equivalent of €500 absolute materiality threshold² for non-retail exposures;
- (iii) remove the PRA’s exercise of the discretion to use 180 days instead of 90 days in the ‘days past due’ component of the definition of default for exposures secured by residential or SME commercial real estate in the retail exposure class and/or exposures to public sector entities (PSEs); and
- (iv) introduce an expectation that firms comply with the GL when applying the CRR definition of default.

Implementation

1.13 In accordance with the EBA Opinion on the implementation of the regulatory review of the IRB Approach,³ the EBA roadmap should be implemented by 31 December 2020. The proposed implementation date for the proposals in this CP is also 31 December 2020.

¹ CRR Article 178(2)(d).

² The figure in sterling to be determined when the rules are made.

³ www.eba.europa.eu/documents/10180/1359456/EBA-Op-2016-01+Opinion+on+IRB+implementation.pdf.

Responses and next steps

1.14 This consultation closes on Monday 29 October 2018. The PRA invites feedback on the proposals set out in this consultation. The PRA would particularly value firms' own estimates of the impact of the proposals. Please address any comments or enquiries to CP17_18@bankofengland.co.uk.

1.15 The proposals in this CP have been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the European Union take effect.

2 Proposals

Materiality thresholds

Proposal

2.1 The PRA proposes to insert a new chapter into the Credit Risk Part of the PRA Rulebook to set a:

- (i) 0% relative materiality threshold and a zero absolute materiality threshold for retail exposure classes; and
- (ii) 1% relative materiality threshold and a sterling equivalent of €500 absolute materiality threshold for non-retail exposure classes.

2.2 Firms would be required to use these materiality thresholds when applying the days past due criterion of the CRR's definition of default.

Rationale

2.3 CRR Article 178(2)(d) requires competent authorities to set a threshold that it considers to reflect a reasonable level of risk.

2.4 The RTS¹ requires a competent authority to set a materiality threshold that reflects a reasonable level of risk where that threshold neither leads to:

- the recognition of an excessive number of defaults that are due to circumstances other than financial difficulties of an obligor; nor
- significant delays in the recognition of defaults that are due to financial difficulties of an obligor.

2.5 The RTS requires competent authorities to set a relative materiality threshold (as a percentage of the size of the exposure)² between 0% and 2.5%, separately for retail and non-retail exposure classes; and an absolute materiality threshold (as a monetary amount) between €0–100 for retail exposure classes and €0–500 for non-retail exposure classes.

2.6 The RTS also requires that if a competent authority sets a relative materiality threshold at a level that deviates from 1%, it must substantiate the choice to the EBA.

¹ CRR Article 178(6)

² The relative materiality threshold is a percentage reflecting the amount of the credit obligation past due in relation to the total amount of all on-balance sheet exposures to that obligor of the institution, the parent undertaking of that institution or any of its subsidiaries, excluding equity exposures.

2.7 Therefore, the aim of this proposal is to set materiality thresholds for retail and non-retail exposure classes that reflect a reasonable level of risk in accordance with the requirements of the RTS.

2.8 The proposed materiality thresholds are to apply irrespective of the payment allocation scheme (ie the method by which firms calculate arrears) used by firms to count days past due.¹

Retail exposure classes

2.9 For retail exposures classes, the PRA proposes to set the relative materiality threshold at 0% and the absolute materiality threshold at zero.

2.10 The PRA considers that a zero threshold reflects a reasonable level of risk when used with the most widely-used payment allocation scheme of UK firms for many retail exposure classes, particularly residential mortgages. This payment allocation scheme is commonly referred to as a 'months in arrears' approach. The PRA considers that a 1% relative threshold² may reflect a reasonable level of risk when used with alternative payment allocation schemes.

2.11 The PRA has set these thresholds on the basis that a materiality threshold higher than zero would lead to a significant delay in the recognition of defaults when used in conjunction with the 'months in arrears' approach.

2.12 The PRA conducted a cost benefit analysis of different levels of materiality threshold and different payment allocation schemes. This indicated that there is no clear prudential benefit of requiring UK firms to change practice from a 'months in arrears' approach, but there is expected to be a high implementation burden. Therefore, it would not be appropriate to require firms to change their payment allocation scheme to set a 1% or any non-zero threshold; or to use a 1% threshold with the 'months in arrears' approach.

Non-retail exposure classes

2.13 For non-retail exposure classes, the PRA proposes to set the relative materiality threshold at 1% and the absolute materiality threshold at the sterling equivalent of €500 as the PRA considers this reflects a level of risk that is reasonable.

2.14 The PRA proposes to set these thresholds on the basis that the 'unlikelihood to pay' default trigger is the main determinant of defaults for non-retail exposure classes. Therefore, using the materiality threshold recommended by the RTS is unlikely to lead to an excessive number of defaults or to significant delays in the recognition of defaults.

2.15 However, the PRA proposes to set an expectation in SS11/13 that firms use a lower materiality threshold for non-retail exposure classes as an indicator of the unlikelihood to pay criterion, if firms consider it to be a more relevant indication of default. Firms should be able to demonstrate that: the lower threshold has been chosen because it is a relevant indication of unlikelihood to pay; that it does not lead to an excessive number of defaults returning to non-defaulted status soon after being recognised as defaults; and that it does not lead to a decrease in capital requirements. This is consistent with the GL.³

1 Commonly used payment allocation schemes include the "money-measure" approach and the "time-measure approach". Approaches and variants under these two categories include a "months in arrears" approach, a "last in first out" approach and a "first in first out" approach.

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

3 Paragraph 34 of the GL.

Removal of the PRA's use of the discretion to replace 90 days with 180 days in the days past due component of the definition of default

Proposal

2.16 The PRA proposes to change its expectation in SS11/13 on exercising the discretion to replace 90 days with 180 days in the days past due component of the CRR's definition of default for exposures secured by residential or SME commercial real estate in the retail exposure class and/or exposures to public sector entities (PSEs).

2.17 The PRA proposes that firms use 90 days past due in the definition of default for all exposure classes.

Rationale

2.18 The PRA set an expectation in SS11/13 that 90 days will be replaced by 180 days for exposures secured by residential real estate in the retail exposure class and/or for exposures to PSEs, where this was requested by the firm.¹

2.19 The EBA Opinion analysed the use of 180 days past due across the EEA and the appropriateness of its application. The EBA Opinion recommends to the European Commission that the use of 180 days past due should be removed from the CRR. The Commission may adopt this recommendation and propose to remove this discretion from the CRR.

2.20 The PRA considers that the use of 90 days past due by all firms for all exposure classes will reduce unwarranted variability and improve the comparability of IRB risk parameters and capital requirements amongst UK firms and across the EEA. It will also ensure that all firms are held to the same prudential standards.

2.21 The PRA also considers that changing the different elements of the definition of default at one time reduces the overall burden of implementation.

2.22 The PRA proposes that firms currently using the 180 days past due discretion are given a transitional period to meet any capital impact from moving to a 90 days past due approach. Firms should engage with their supervisors to agree an appropriate transitional period.

Guidelines on the application of the definition of default

Proposal

2.23 The PRA proposes to amend SS11/13 to reflect that firms should comply with the GL when applying the CRR definition of default.

Rationale

2.24 The GL provide guidance on the application of the CRR's definition of default. Specifically, they provide guidance on the days past due criterion, including the counting of days past due and the assessment of a technical past due situation; indicators of unlikeliness to pay; the application of the definition of default to external data; the criteria for exposures to return to non-defaulted status (ie cures); the consistent application of the definition of default; the application of the definition of default to retail exposures; and the documentation, internal policies and risk management processes relating to the definition of default.

2.25 The PRA considers that firms' compliance with the GL will reduce unwarranted variability and improve the comparability of IRB risk parameters and capital requirements.

¹ CRR Article 178(1)(b).

3 The PRA's statutory obligations

3.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations.

3.2 Before making any rules, the Financial Services and Markets Act 2000 (FSMA)¹ requires the PRA to publish a draft of the proposed rules accompanied by:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed rules is compatible with the PRA's duty to act in a way that advances its general objective,² insurance objective³ (if applicable), and secondary competition objective;⁴
- an explanation of the PRA's reasons for believing that making the proposed rules are compatible with its duty to have regard to the regulatory principles;⁵ and
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.⁶

3.3 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.⁷

3.4 The PRA is also required by the Equality Act 2010⁸ to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.5 This CP proposes to insert a new chapter in the Credit Risk Part of the PRA Rulebook and update the PRA's expectations for certain elements of the CRR's definition of default. The PRA is required to perform a cost benefit analysis of the impact of its policy proposals.

Overall cost benefit analysis

3.6 The benefits of the proposals in this CP arise from clarification of the application of the CRR requirements on the definition of default. This should reduce unwarranted variability and increase the comparability of IRB risk parameters and capital requirements, both among UK firms, and between UK firms and other EEA firms.

3.7 The proposals will promote the safety and soundness of firms by ensuring that IRB risk parameters and capital requirements are prudent and that differences in estimates across firms are based on risk and not on different practices or interpretations. This will help to restore confidence that IRB risk parameters and capital requirements are consistently based on safe and sound practices.

1 Section 138J of FSMA.

2 Section 2B of FSMA.

3 Section 2C of FSMA.

4 Section 2H(1) of FSMA.

5 Sections 2H(2) and 3B of FSMA.

6 Section 138K of FSMA.

7 Section 30B of the Bank of England Act 1998.

8 Section 149.

3.8 The PRA considers that some firms will incur an operational cost from the proposals, mainly from introducing a non-zero relative and absolute materiality threshold for non-retail exposures, and from switching to using 90 days past due from 180 days past due.

3.9 Firms that are required to move from using 180 days past due to using 90 days past due may be required to maintain additional capital against these exposures, but the PRA considers that any such increase is justified on the basis of improving the comparability of IRB risk parameters and improving market participants' confidence in capital requirements.

3.10 Overall, the PRA believes that the proposals in this CP achieve the right balance between the benefits and the costs.

Cost benefit analysis of the PRA's proposals for the materiality thresholds

Benefits

3.11 A benefit of the PRA's materiality thresholds proposals is that they avoid a burdensome change in practice for UK firms when there is a lack of clarity as to whether this change will be prudentially better. This approach will also limit the extent to which historical default data sets may be based on a different definition of default to future defaults, and as such maintain the representativeness of the available data history.

3.12 In addition, the PRA has proposed to maintain alignment with the EBA's recommended threshold for non-retail exposures, which will reduce variability and enhance comparability. For retail exposures, the PRA has proposed to tailor the approach to the United Kingdom, within the EBA's parameters, which is justified and appropriate for such exposures in order to reflect a reasonable level of risk.

3.13 An alternative proposal that sets non-zero thresholds for retail exposures may affect exposure classes differently, depending on the materiality of contractual repayments, and may not be prudent for exposure classes with relatively low contractual payments (eg interest only mortgages).

Assessing the capital impact

3.14 The PRA does not consider that there will be a significant capital impact resulting from the proposals for the materiality threshold. This is because the materiality threshold proposals in this CP should not require firms to make large changes to their current practices.

3.15 The PRA has considered whether different relative and absolute thresholds will better reflect a reasonable level of risk by assessing if they unduly accelerate or delay the recognition of a default. Bringing forward the recognition of a default will result in more defaults being recognised. Intuitively, this might seem more prudent. But if this leads to an increase in loans being classified as defaulted that then subsequently cure (ie not genuine defaults), loss estimates on average will be lower.

3.16 This will likely lead to higher PD estimates and lower LGD estimates. The impact on capital requirements is unclear and will be dependent on the extent to which the decrease in LGD offsets the increase in PD. Furthermore, some firms may not be able to realise the full decrease in LGD due to the CRR's 10% portfolio-level LGD floor for retail exposures secured by

residential property and the 15% portfolio-level LGD floor for retail exposures secured by commercial immovable property.¹

3.17 Any proposal that brings forward the point of default may increase the stock of defaulted exposures, if they do not subsequently cure. For SA firms, this will typically increase overall capital requirements as defaulted exposures have relatively higher risk weights. For IRB firms, the impact is less clear and will depend on the firms' modelling methodology.

3.18 Therefore, the PRA considers there to be no clear prudential benefit from accelerating or delaying the recognition of a default relative to the point of recognition under current UK practice.

Other costs

3.19 Firms with non-retail exposures could incur costs from introducing non-zero relative and absolute materiality threshold in their models and systems.

Cost benefit analysis of the proposal to remove the PRA's exercise of the discretion to replace 90 days with 180 days in the days past due component of the definition of default

Benefits

3.20 A benefit of removing the discretion to use 180 days past due is to increase the comparability of IRB parameters and capital requirements across UK firms, and between UK and EEA firms. It should also result in operational benefits for firms with entities in the UK and the EEA who will be expected to use a consistent number of days past due across their EEA group.

3.21 It is possible that the European Commission will implement the recommendations of the EBA Opinion and propose to remove the use of 180 days past due from the CRR in the future. Therefore, the PRA's proposals enable firms to make all changes to their definition of default at the same time, which will reduce the burden of implementation.

3.22 Some firms are also likely to benefit due to consistency with accounting standards. Under International Financial Reporting Standard (IFRS) 9, firms are likely to use 90 days past due in their classification of exposures as credit-impaired.²

3.23 Furthermore, the European Commission's 'Action Plan on the Reduction of Non-Performing Loans in Europe'³ uses 90 days past due as part of its classification of a loan as non-performing.

Costs

3.24 As set out in the previous section, changing the point at which a default is recognised is likely to impact capital requirements. The PRA expects that there may be a capital impact from the proposal to remove the use of 180 days past due as defaults are recognised earlier. The capital impact should be managed by the proposed transitional period, to be agreed with their supervisors.

1 Article 164(4).

2 IFRS 9 contains a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due, unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate.

3 www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/ and http://ec.europa.eu/finance/docs/policy/180314-communication-non-performing-loans_en.pdf

3.25 Firms currently using 180 days past due will also face an implementation burden to change their systems, processes and default database to a 90 days past due measure.

Compatibility with the PRA's objectives

3.26 As set out in the cost benefit analysis section, the proposals in this CP should contribute to maintaining the safety and soundness of firms by ensuring an appropriate recognition of defaults and prudent estimates of capital requirements for both defaulted and non-defaulted assets. It will also help to ensure that any differences in IRB risk parameters or capital requirements are based on risk and not on different practices or interpretations.

3.27 The PRA has also assessed whether the proposals in this CP facilitate effective competition. The proposals for the materiality thresholds and the GL should not impact competition as the thresholds apply equally to firms, irrespective of whether they use the IRB approach or SA for calculating capital requirements for credit risk.

3.28 The proposal to remove the use of 180 days past due should facilitate competition. Requiring all firms that use the IRB approach to use the same number of days past due in their definition of default should ensure greater consistency across IRB firms. Furthermore, SA firms are already required to use 90 days past due, so the proposal will increase consistency between SA and IRB firms. This should also facilitate competition.

Regulatory principles

3.29 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. Three of the principles are of particular relevance.

3.30 The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction: the PRA considers that the burden of the proposals would be proportionate to the benefits, as set out in the cost benefit analysis.

3.31 The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term: the PRA expects the proposals to contribute to sustainable economic growth by promoting the resilience of the firms that provide core financial services. Reducing unwarranted variability in firms' capital requirements should help to renew confidence amongst investors and other market participants in firms' capital strength.

3.32 The desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons subject to requirements imposed by or under FSMA: the PRA has set different materiality thresholds for retail and non-retail exposures classes, which accounts for the differences in the nature of recognising defaults between these two exposure classes.

Impact on mutuals

3.33 The PRA considers that the impact of the proposed rule changes on mutuals is expected to be no different from the impact on other firms.

HM Treasury recommendation letter

3.34 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.¹

3.35 The aspects of the Government's economic policy most relevant to the proposals in this CP are (i) competition; (ii) growth; and (iii) competitiveness.

3.36 Aspects (i) and (ii) have been considered in the 'compatibility with the PRA's objectives' and 'regulatory principles' sections above. Consideration of aspect (iii) on competitiveness is set out below.

Competitiveness

3.37 An intention of the proposals in this CP is to reduce the unwarranted variability of definitions, interpretations and practices within the IRB model framework. Given that the EBA's regulatory products will apply to all EEA firms, they should increase consistency of modelling approaches and capital requirements across EEA firms. Therefore, the PRA does not consider that the proposals will inhibit or disadvantage the competitiveness of the UK banking industry.

Equality and diversity

3.38 The PRA has performed an assessment of the policy proposals in this CP and does not consider that the proposals give rise to equality and diversity implications.

¹ Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at www.bankofengland.co.uk/about/Pages/people/prapeople.aspx.

Appendices

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- 1 Draft amendments to Supervisory Statement 11/13 'Internal Ratings Based (IRB) approaches'**
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- 2 Draft Credit Risk (Amendment) Instrument 2018**
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Appendix 1: Draft amendments to Supervisory Statement 11/13 'Internal Ratings Based (IRB) approaches'

This appendix outlines proposed amendment to [SS11/13 'Internal Ratings Based \(IRB\) approaches'](#). Underlining indicated new text and striking through indicated deleted text.

...

11 Definition of default

11.A1 When applying the definition of default in CRR Article 178, the PRA expects firms to comply with the EBA's Guidelines on the application of the definition of default (EBA/GL/2016/07).

Identification of obligors

11.1 The PRA expects that if a firm ordinarily assigns exposures in the corporate, institution or central government and central bank exposure classes to a member of a group substantially on the basis of membership of that group and a common group rating, and the firm does so in the case of a particular obligor group, the firm should consider whether members of that group should be treated as a single obligor for the purpose of the definition of default set out in CRR Article 178(1).

11.2 The PRA would not expect a firm to treat an obligor as part of a single obligor under the preceding paragraph if the firm rated its exposures on a standalone basis or if its rating was notched. (For these purposes a rating is notched if it takes into account individual risk factors, or otherwise reflects risk factors that are not applied on a common group basis.) Accordingly, if a group has two members which are separately rated, the PRA would not expect that the default of one would necessarily imply the default of the other.

Days past due

11.3 Under CRR Article 178(2)(d) the PRA is empowered to replace 90 days with 180 days in the days past due component of the definition of default for exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to public sector entities (PSEs).

11.4 ~~We would~~ The PRA does not expect to replace 90 days with 180 days in the days past due component of the definition of default for any exposure class, ~~exposures secured by residential real estate in the retail exposure class, and/or for exposures to PSEs, where this was requested by the firm. Where this occurred, it would be specified in a firm's IRB permission.~~

Unlikelihood to pay: use of materiality thresholds

11.4A The PRA expects firms to use a lower materiality threshold than that set by the PRA¹ as an indicator of unlikelihood to pay for non-retail exposure classes, if the lower threshold is a more relevant indication of default. When using a lower materiality threshold, firms should ensure compliance with paragraph 34 of the EBA's Guidelines on the application of the definition of default (EBA/GL/2016/07).

1 Rule 6.1 of the Credit Risk Part of the PRA Rulebook.

Unlikelihood to pay: distressed restructuring

11.5 The PRA expects that a credit obligation be considered a distressed restructuring if an independent third party, with expertise in the relevant area, would not be prepared to provide financing on substantially the same terms and conditions. Firms should comply with paragraphs 49 to 55, 72, 73 and 107 of the EBA Guidelines on the application of the definition of default (EBA/GL/2016/07), which cover the treatment of distressed restructuring as an unlikelihood to pay criterion.

(CRR Article 178(2)(d))

Return to performing status

11.6 In order to be satisfied that a firm complies with the documentation requirements set out in CRR Article 175(3) the PRA expects that a firm should have a clear and documented policy for determining whether an exposure that has been in default should subsequently be returned to performing status. Firms should also comply with Chapter 7 of the EBA Guidelines on the application of the definition of default (EBA/GL/2016/07), which covers the return to non-defaulted status.

(CRR Article 175(3))

...

Appendix 2: Draft Credit Risk (Amendment) Instrument 2018

PRA RULEBOOK: CRR FIRMS: CREDIT RISK (AMENDMENT) INSTRUMENT 2018

Powers exercised

- A. The Prudential Regulation Authority (“PRA”) makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137G (The PRA’s general rules); and
 - (2) section 137T (General supplementary powers).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

Pre-conditions to making

- C. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

PRA Rulebook: CRR Firms: Credit Risk (Amendment) Instrument 2018

- D. The PRA makes the rules in the Annex.

Commencement

- E. This instrument comes into force on 31 December 2020.

Citation

- F. This instrument may be cited as the PRA Rulebook: CRR Firms: Credit Risk (Amendment) Instrument 2018.

By order of the Prudential Regulation Committee

[DATE]

Annex

Amendments to the Credit Risk Part

In this Annex new text is underlined.

1 APPLICATION AND DEFINITIONS

...

1.2 In this Part, the following definitions shall apply:

equity exposures

means exposures that meet the criteria in either:

- (1) Article 133 of the CRR; or
- (2) Article 147(6) of the CRR, if a firm has permission to use internal models in accordance with Chapter 3, Title II, Part Three of the CRR.

...

non-retail exposures

means exposures that are not retail exposures, in accordance with Commission Delegated Regulation (EU) 2018/171.

retail exposures

means exposures that meet the criteria in either:

- (1) Article 123 of the CRR; or
- (2) Article 147(5) of the CRR, if a firm has permission to use internal models in accordance with Chapter 3, Title II, Part Three of the CRR.

...

6 MATERIALITY THRESHOLD

6.1 For the purposes of Article 178(1)(b) of the CRR, a firm must assess a credit obligation past due as material if:

(1) for retail exposures:

- (a) the sum of all amounts past due owed by an obligor to the firm, any parent undertaking of the firm or any subsidiary of the firm is greater than €0; and
- (b) the amount of the credit obligation past due in relation to the total amount of all on-balance sheet exposures to that obligor of the firm, any parent

undertaking of the firm or any subsidiary of the firm, excluding equity exposures, is greater than 0%;

(2) for non-retail exposures:

(a) the sum of all amounts past due owed by an obligor to the firm, any parent undertaking of the firm or any subsidiary of the firm is equal to or greater than [EUR 500 sterling equivalent]; and

(b) the amount of the credit obligation past due in relation to the total amount of all on-balance sheet exposures to that obligor of the firm, any parent undertaking of the firm or any subsidiary of the firm, excluding equity exposures, is equal to or greater than 1%.

[Note: Arts. 178(1)(b) and 178(2)(d) of the CRR]