

Policy Statement | PS7/19

# Credit risk: the definition of default

March 2019



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY





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## 1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 17/18 'Credit risk: definition of default'.<sup>1</sup> It also contains the PRA's final policy, as follows:

- an amendment to the Credit Risk Part of the PRA Rulebook to set thresholds for determining whether a credit obligation is material for the purpose of the Capital Requirements Regulation's (575/2013) (CRR's)<sup>2</sup> definition of default (Appendix 1); and
- an update to the PRA's expectations in Supervisory Statement (SS) 11/13 'Internal Ratings Based (IRB) approaches' to implement the European Banking Authority's (EBA's) regulatory products that relate to the definition of default (Appendix 2).

1.2 This PS is relevant to UK Banks, building societies and PRA-designated investment firms.

### Background

1.3 The EBA has developed a roadmap of regulatory products ('EBA roadmap') with the aim of reducing unwarranted variability in risk-weighted assets (RWAs) across banks for credit risk.<sup>3</sup>

1.4 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 due<sup>4</sup> and the Guidelines on the application of the definition of default ('the GL').<sup>5</sup> The PRA has informed the EBA that it intends to comply with the GL. The EBA has also published a third product on the definition of default: an 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').<sup>6</sup>

1.5 CP17/18 set out the PRA's proposed approach to implementing these three products. The PRA proposed to:

- set a 0% relative materiality threshold and a zero absolute materiality threshold for retail exposures;
- set a 1% relative materiality threshold and a sterling equivalent of €500 absolute materiality threshold for non-retail exposures;
- 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 real

<sup>1</sup> July 2018, page 2 of 2: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-the-definition-of-default>.

<sup>2</sup> CRR Article 178(2)(d).

<sup>3</sup> <https://eba.europa.eu/-/eba-sets-out-roadmap-for-the-implementation-of-the-regulatory-review-of-internal-models>.

<sup>4</sup> [http://data.europa.eu/eli/reg\\_del/2018/171/oj](http://data.europa.eu/eli/reg_del/2018/171/oj).

<sup>5</sup> <https://eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-the-application-of-the-definition-of-default>.

<sup>6</sup> <https://eba.europa.eu/-/eba-advises-the-commission-to-disallow-the-application-of-the-180-day-past-due-exemption-for-material-exposures>.

estate or small and medium sized enterprise (SME) commercial real estate in the retail exposure class, and/or exposures to public sector entities (PSEs); and

- introduce an expectation that firms comply with the GL when applying the CRR definition of default.

1.6 The proposals relating to the RTS and GL apply to firms using the standardised approach ('SA firms') and to firms using the IRB approach ('IRB firms') for calculating the capital requirements for credit risk.<sup>7</sup> The proposals relating to the EBA Opinion apply to IRB firms only.

### Summary of responses

1.7 The PRA received ten responses to the CP. Respondents generally supported the PRA's proposals. Some consultation responses outlined specific concerns and requests for clarification. Specific areas where the PRA has amended or clarified the proposals are detailed in Chapter 2.

1.8 The PRA considers the main issues raised during consultation to relate to the:

- (i) proposal to remove the use of 180 days past due;
- (ii) implementation deadline of end-2020 for the entire EBA roadmap;
- (iii) application of the materiality thresholds to banking groups with cross-border entities; and
- (iv) use of the materiality thresholds when a 'months in arrears' approach is not used.

1.9 The PRA's responses to these four issues are set out in paragraphs 2.3 to 2.24.

### Changes to draft policy

1.10 Where the final rules differ from the draft proposals in the CP in a way which is, in the opinion of the PRA, significant, the Financial Services and Markets Act 2000 (FSMA)<sup>8</sup> requires the PRA to publish:

- (a) details of the difference together with a cost-benefit analysis; and
- (b) a statement setting out in the PRA's opinion whether or not the impact of the final rule on mutuals is significantly different to the impact that the draft policy would have had on mutuals; or the impact that the final rule will have on other PRA-authorized firms.

1.11 Two changes have been made to the final rule from the draft policy in the CP:

- (i) all references to the year '2018' have been updated to '2019'; and
- (ii) references to 'equal to or' in paragraph 6.1(2)(a) and (b) of the PRA rule have been deleted (see paragraph 2.25 for more detail).

1.12 One change has been made to the draft amendments to SS11/13: the definition of 'distressed restructuring' in paragraph 11.5 of SS11/13 has been updated to align with the GL

<sup>7</sup> CRR Articles 127 and 178.

<sup>8</sup> Section 138J(5) and 138K(4).

and Financial Reporting (FINREP) (see paragraph 2.32 in this PS for more detail). The PRA has also corrected the CRR reference after paragraph 11.5 of SS11/13.

1.13 The PRA considers that the changes to the final PRA rule are not significant and will not materially alter the cost benefit analysis presented in the CP. They are both minor technical updates to improve the accuracy of the rule and clarity for firms. The PRA does not consider that the impact of the final rule will have a significantly different impact on mutuals relative to the impact of the draft rule on mutuals, or the impact of the final rule on other PRA-authorized firms. See Appendix 1 for the final PRA rule.

1.14 The PRA does not consider that the change to the final SS11/13 will have a significant impact relative to the draft SS11/13 in the CP. The change was made to align the definition of 'distressed restructuring' with the GL and FINREP, which should have a positive impact for firms, as it will result in a consistent definition being used. The PRA does not consider that the impact of the final updated SS11/13 will have a significantly different impact on mutuals relative to the impact of the draft SS11/13 on mutuals, or the impact of the final updated SS11/13 on other PRA-authorized firms.

### Implementation and next steps

1.15 The PRA rule and updates to SS11/13 apply from Thursday 31 December 2020, unless a firm attains supervisory approval to extend this application date (see paragraph 2.10 to 2.15).

1.16 The PRA intends to publish a further 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;<sup>9</sup> the RTS that specifies the nature, severity and duration of an economic downturn;<sup>10</sup> and the Guidelines for the estimation of LGD appropriate for an economic downturn.<sup>11</sup> This CP will be published after the EBA has finalised the relevant regulatory products.

1.17 The policy set out in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA has assessed that no additional amendments would need to be made to the changes outlined in this PS in the event that the UK leaves the EU with no implementation period in place on 29 March 2019. Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'<sup>12</sup> for further information on the Bank's amendments to rules and standards under the European Union (Withdrawal) Act 2018; Bank of England Statement of Policy (SoP) 'Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU';<sup>13</sup> and SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.<sup>14</sup>

<sup>9</sup> <https://eba.europa.eu/regulation-and-policy/model-validation/guidelines-on-pd-lgd-estimation-and-treatment-of-defaulted-assets>.

<sup>10</sup> <https://eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-the-specification-of-an-economic-downturn> (Note: this is not the final version of the RTS, as it has yet to be adopted by the European Commission and published in the Official Journal of the EU).

<sup>11</sup> Not yet published by the EBA.

<sup>12</sup> February 2019: <https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018>.

<sup>13</sup> February 2019: <https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop>.

<sup>14</sup> February 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss>.

## 2 Feedback to responses

2.1 Before making any proposed rules, the PRA is required by the FSMA to have regard to any representations made to it, and to publish an account, in general terms, of those representations and its response to them.<sup>15</sup>

2.2 This section provides the PRA's feedback to the consultation responses received, including any amendments or clarifications made. The consultation responses have been grouped into four main topics and other responses, as follows:

- removal of the use of 180 days past due;
- implementation deadline of end-2020;
- application of materiality thresholds to banking groups with cross-border entities;
- use of materiality thresholds when a 'months in arrears' approach is not used; and
- other responses.

### Removal of the use of 180 days past due

2.3 In CP17/18, the PRA proposed to update its expectations in SS11/13 by removing 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 exposures to PSEs.

2.4 The PRA received several responses to this proposal. The majority of responses supported the proposal. Respondents that supported the policy change noted that it should reduce unwarranted variability and increase comparability of IRB RWAs, and that the alignment of the timing of this change with all other changes to the definition of default was preferable.

2.5 Some responses raised concerns with the proposal, including that:

- it would be burdensome to implement;
- it could increase capital requirements when made in conjunction with other IRB changes;
- 90 days past due may not be a strong indicator of defaults as it has a high cure rate;
- a rise in RWAs from this change could lead to an increase in mortgage pricing; and
- the UK mortgage market is very mature, so alignment with the EU is not appropriate.

2.6 The PRA has considered these responses and provides the following feedback below.

2.7 The PRA has decided to retain the proposed policy to remove the use of 180 days past due. This approach helps align the definition of default across UK firms and with European Economic Area (EEA) firms. This should reduce unwarranted variability and improve the comparability of IRB RWAs, which should help to restore confidence in IRB capital requirements.

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<sup>15</sup> Sections 138J(3);2L; and 138J(4) of FSMA.



2.8 The PRA reiterates that firms can agree a transitional period, if appropriate, to meet any increase in capital requirements resulting from moving to 90 days past due. Any such transitional should be agreed on a case-by-case basis with the firm's supervisor.

2.9 Firms are encouraged to use 90 days past due for hybrid mortgage model applications. The PRA considers that it is unlikely to be credible to submit a hybrid model for approval that uses 180 days past due, and have a fully compliant model using 90 days past due by end-2020.

### **Implementation deadline of end-2020**

2.10 In CP17/18, the PRA's proposed implementation date for all the proposals relating to the definition of default was 31 December 2020. This is consistent with the EBA Opinion on the implementation of the regulatory review of the IRB Approach,<sup>16</sup> which states that the entire EBA roadmap should be implemented by 31 December 2020.

2.11 Some respondents raised a concern with the feasibility of achieving the implementation deadline of 31 December 2020. The PRA has considered the responses and provides feedback below.

2.12 The implementation deadline for the materiality thresholds set out in the PRA rule, and compliance with the entire EBA roadmap, is end-2020. In the event that a firm cannot meet the end-2020 implementation deadline for all IRB models, the firm should discuss this with their supervisor. Where the end-2020 deadline cannot be met for the PRA rule, firms can consider applying for a temporary waiver of rule 6.1 of the Credit Risk Part in order to delay the implementation date for the materiality threshold for some asset classes.

2.13 Firms should make every effort to comply with the GL, but where they cannot meet the end-2020 implementation deadline, the firm should discuss submission of a remediation plan with their supervisor.

2.14 The PRA, however, expects firms to prioritise model changes to residential mortgage portfolios by end-2020. The PRA also expects firms to prioritise changes to other models that are for the most material asset classes for the firm, or where they are of a similar materiality to mortgage models, by end-2020. For the avoidance of doubt: the PRA expects all the EBA roadmap products, and not just the definition of default changes, to be implemented for residential mortgage portfolios, and any other identified material asset classes, by end-2020. In addition, the PRA does not expect to permit a firm to extend its implementation of the EBA roadmap for less material exposure classes beyond end-2021. Should the EBA announce any changes to the implementation timeline, firms should discuss the potential implications of this with their supervisor.

2.15 Firms should also engage with their supervisor to discuss their implementation approach for those exposures for which Basel III removes the use of the Advanced IRB approach.

### **Application of materiality thresholds to banking groups with cross-border entities**

2.16 Some respondents requested clarity on whether the PRA will recognise the materiality thresholds set by other EEA competent authorities and third country prudential regulators ('local thresholds') or whether the PRA's proposed materiality thresholds will apply at the UK consolidation group level to all exposures. The PRA has considered the responses and provides feedback below.

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<sup>16</sup> <https://eba.europa.eu/documents/10180/1359456/EBA-Op-2016-01+Opinion+on+IRB+implementation.pdf>.



2.17 Rule 6.1 of the Credit Risk Part of the PRA Rulebook requires a firm to apply the PRA's materiality thresholds to all of its exposures on a UK individual solo level and, if applicable, UK consolidation group level. When applying materiality thresholds at a solo level, overseas subsidiaries of UK firms are expected to apply the relevant local thresholds. However, the PRA expects firms to apply for a rule modification<sup>17</sup> to modify rule 6.1 in order to also apply local thresholds for these overseas subsidiaries at the UK consolidation group level where, taking into account the local market characteristics, economic conditions, and financial risk, it would be more appropriate to apply the local thresholds than the PRA's thresholds.<sup>18</sup> SS11/13 has been updated to reflect this expectation. In respect of certain jurisdictions, the PRA may make available a 'modification by consent' and, if so, would provide details of the modification on the PRA's webpages.<sup>19</sup>

2.18 In order to grant the waiver, the PRA would need to be satisfied, among other factors, that using the PRA thresholds instead of local thresholds, does not achieve the purpose for which the rule was made or is unduly burdensome.<sup>20</sup> The PRA anticipates that the materiality thresholds set by other EEA component authorities that comply with the RTS would be likely to meet the conditions for a modification. Similarly, materiality thresholds set by third country prudential regulators that are set in line with the parameters of the RTS may meet the modification conditions. But, where a materiality threshold set by a third country regulator is not set in line with the parameters of the RTS, firms should provide supporting information on the appropriateness of the local thresholds. In such cases, firms may want to demonstrate that the local thresholds are appropriate for the local market characteristics, economic conditions, and financial risk; and lead neither to the recognition of an excessive number of defaults that are due to other circumstances than financial difficulties of an obligor nor to significant delays in the recognition of defaults that are due to financial difficulties of an obligor. Firms should provide supporting information about the appropriateness of local thresholds for all waiver applications.

2.19 The PRA expects firms to apply for a modification for all jurisdictions in which the local thresholds are more appropriate, and not only those jurisdictions for which they expect the use of local thresholds to reduce capital requirements.

### **Use of materiality thresholds when a 'months in arrears' approach is not used**

2.20 The PRA's final materiality thresholds for retail exposure classes are: a 0% relative materiality threshold and a zero absolute threshold. These thresholds are designed to be appropriate for when a 'months in arrears' payment allocation scheme is used by the firm.

2.21 Some respondents asked if a different materiality threshold should be used for retail exposure classes when a 'months in arrears' approach is not used. Some respondents also suggested that there may be a need to set a non-zero threshold to exclude small amounts in arrears where a time-based payment allocation scheme is used. The PRA has considered the responses and provides feedback below.

2.22 While the retail materiality thresholds have been designed to be appropriate for the 'months in arrears' approach, they are applicable to all retail exposures, irrespective of the payment scheme used. The RTS only permits the PRA to set one relative and one absolute materiality threshold for retail exposures, and one relative and one absolute materiality

<sup>17</sup> Under section 138A of the Financial Services and Markets Act 2000.

<sup>18</sup> This also applies to a scenario where UK firms passport into other jurisdictions, such that it is a UK firm with an exposure in a different jurisdiction.

<sup>19</sup> <https://www.bankofengland.co.uk/prudential-regulation>.

<sup>20</sup> Section 138A(4)(a) FSMA.

threshold for non-retail exposures. Therefore, it is not permitted to set different thresholds for different retail sub-asset classes.

2.23 The PRA is not prescriptive on the type of payment allocation scheme used by firms.

2.24 The PRA investigated setting a non-zero absolute threshold for retail exposures. This was considered with the intention of excluding low material past due amounts for certain retail sub-asset classes. However, the PRA's analysis indicates that this will introduce unnecessary complexity; it may cause undue delay in the recognition of defaults; and is not compatible with the use of the 'months in arrears' approach which, by construct, has an in-built monetary threshold.

### Other responses

2.25 One respondent suggested deleting the words 'equal to or' from the proposed paragraph 6.1(2)(a) and (b) of the PRA rule in order to align fully with the RTS. This change should ensure that the size of the amount past due must exceed, but not be equal to, both the absolute and relative threshold to trigger a default. The PRA agrees with this suggestion to align the PRA rule with the RTS. The PRA rule has been updated accordingly.

2.26 One respondent requested clarity on whether it is possible to have different materiality thresholds within the same rating system or exposure class and, as a consequence, if an obligor can change default status when moving between exposure classes due to different materiality thresholds. The PRA would not typically expect a firm to have different exposure classes within the same rating system. But the PRA recognises that there are situations where this could occur, such as where an SME exposure can be classified as a retail or corporate exposure, depending on the size of the exposure.<sup>21</sup> The RTS and the PRA's proposals do not explicitly prohibit the use of retail and non-retail thresholds within the same rating system, if that rating system covers a retail and non-retail asset class. However, it could be operationally challenging to adopt two different thresholds within the same rating system. And, for example, if the retail SME and corporate SME exposures are very similar in characteristics and risk (and, for instance, just differ in terms of their exposure amounts), firms should examine whether they should be treated consistently from a definition of default perspective. In this example, firms should consider the appropriateness of the non-retail thresholds for corporate SME exposures that are modelled with retail SME exposures. One way of achieving this is to follow paragraph 34 of the GLs, which allows a firm to apply a lower materiality threshold for non-retail exposures as an indicator of unlikeliness to pay.

2.27 Some respondents requested clarity on the use of a lower materiality threshold as an indicator of unlikeliness to pay for non-retail exposures. The PRA considers that firms will need to make their own assessment of this in accordance with the GL.

2.28 Some respondents provided feedback on the currency conversion of the absolute threshold for non-retail exposures. Respondents noted a concern that exchange rate fluctuations could lead to excessive volatility in the definition of default. Therefore, the PRA has decided against setting a currency conversion in the PRA rule. Instead, firms should adopt an appropriate methodology for converting the Euro non-retail absolute threshold into Sterling. This methodology should include the frequency of the conversion, reflecting the need to balance stability and accuracy. Firms should have clear policies in place for the process of converting and updating the threshold. Firms should document both the methodology used

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<sup>21</sup> CRR Article 147(5).

and policies adopted, and include both as part of any model approval or change application to the PRA, for supervisory review.

2.29 One respondent requested clarity on how to reconcile the use of the months in arrears payment scheme with the GL requirement that the specific date of default needs to be identified for a default event. The PRA notes that paragraph 21 of the GL states that where firms calculate days past due less often than daily, they should ensure that the date of default is identified as the date when the past due criterion has actually been fulfilled. In addition, the PRA notes that paragraph 38 and 43(a)(i) of the EBA's Guidelines on PD estimation, LGD estimation, and the treatment of default exposures<sup>22</sup> permits firms to apply an "appropriate adjustment" to correct the identified model deficiencies and account for any subsequent increased uncertainty or estimation error via the calculation of margin of conservatism.

2.30 One respondent raised the concern that a relative threshold for non-retail exposures will be difficult to systematise if an absolute threshold is already in place. The PRA notes that the RTS requires the PRA to set both a relative and absolute threshold for retail and non-retail exposures.

2.31 One respondent raised the concern of the burden of having to restate historic default databases to reflect a new definition of default. The PRA acknowledges the potential burden, but considers it appropriate that firms restate or update historic default databases, if necessary.

2.32 One respondent raised the concern of potential non-alignment with the definition of default under the accounting and non-performing loan frameworks, specifically citing that the definition of 'distressed restructuring' in paragraph 11.5 of SS11/13 should be aligned with the GL and, therefore, the definition of 'forbearance' in FINREP. The PRA agrees with this feedback and will delete the existing definition of 'distressed restructuring' in paragraph 11.5 of SS11/13, and replace it with a reference to the GL in order to achieve alignment of definitions relevant to the definition of default (See Appendix 2).

2.33 One respondent sought clarity on the PRA's model review process and requested open dialogue with the PRA. The PRA is open for dialogue and firms should agree an implementation and model review plan with their supervisor.

2.34 One respondent asked how frequently a 'Foundation IRB bank' needs to verify that they are not overstating defaults and cures if using a lower materiality threshold for non-retail exposures, as permitted by paragraph 34 of the GLs. The PRA expects firms to monitor this on an ongoing basis and to re-assess as and when appropriate.

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<sup>22</sup> <https://eba.europa.eu/regulation-and-policy/model-validation/guidelines-on-pd-lgd-estimation-and-treatment-of-defaulted-assets>.

## Appendices

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- 1 PRA RULEBOOK: CRR FIRMS: CREDIT RISK (AMENDMENT) INSTRUMENT 2019, available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-the-definition-of-default>

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- 2 Supervisory Statement 11/13 UPDATE 'Internal Ratings Based (IRB) approaches', available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/internal-ratings-based-approaches-ss>