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# Final Report

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

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# 1. Executive Summary

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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 the 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 to the application of the definition of default of an obligor.

The EBA has identified differing practices used by 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 unlikelihood to pay, conditions for a 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 to retail exposures. The EBA considers this harmonisation necessary in order to ensure a consistent use of the definition of default and to ensure that a harmonised approach is taken across institutions and jurisdictions. As a result the guidelines 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 – thus reducing overall RWA variability across institutions.

The EBA performed a qualitative and quantitative assessment of the potential impact of these guidelines on institutions' capital requirements. The results indicate that, although the overall level of capital requirements should not change significantly, the dispersion of the impact of some policy proposals across individual institutions is broad and hence some institutions will be more significantly affected than others.

It is expected that the implementation of these guidelines may require significant effort and resources 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 the default definition, as a result of either these guidelines or any other changes that may be necessary, these guidelines also consider the implementation process and consequently propose to implement the guidelines only after a phase-in period.

## Next steps

The guidelines will be translated into the official EU languages and published on the EBA website. The deadline for competent authorities to report whether they comply with the guidelines will be two months after the publication of the translations. The guidelines will apply from 1 January 2021, but the EBA encourages institutions to implement the changes prior to this date in order to build the necessary time series.

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## 2. Background and rationale

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The definition of default was 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 (CRR). The definition of default of an obligor specified in Article 178 of the CRR includes, inter alia, the days past due criterion for default identification, indications of unlikelihood to pay, conditions for a 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 the CRR 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 the 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 have established their own detailed rules for the identification of default based on their experience and portfolio characteristics, resulting in a substantial variation in these practices across institutions. This is consequently a driver of the variability of risk estimates and capital requirements, and therefore reduces comparability of these measures across institutions.

The definition of default influences own funds requirements both under the IRB Approach 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 the assignment of exposures to the class of exposures in default in line with Article 127 of the CRR.

As certain choices in the application of the default definition may have a significant impact on own funds requirements it is important to ensure a level playing field across institutions in the entire EU. Therefore, these guidelines provide detailed guidance on the application of various aspects of the definition of default, including the past due criterion as an indication of default, indications of unlikelihood 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 a return to 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 of complying with different requirements in different Member States.

### 2.1 Implementation of the changes in the definition of default

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

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the currently used definition of default is significantly different from the proposed rules. The institutions that use the IRB Approach will not only have to change their default identification processes and possibly IT systems but will also have to recalibrate their rating systems. For that reason it was considered appropriate to allow institutions sufficient time to introduce the required changes and to provide additional guidance on the main aspects of the implementation process.

## 2.2 Past due criterion in the identification of default

### 2.2.1 Counting of days past due

In the area of the counting of days past due harmonisation will be achieved predominantly through the RTS on the materiality threshold for past due exposures specified in accordance with Article 178(6) of the CRR. However, the draft guidelines provide clarification on those aspects of counting of days past due that are not covered in these RTS. In particular, it has been specified that if 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 a specific business strategy or may stem from national regulations related to consumer protection.

Similar considerations apply to a situation where repayments are suspended by force of law. As the client is legally not obliged to make 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 obligor; therefore, institutions should assess the obligor for possible indications of unlikelihood to pay.

If there is a dispute between the obligor and the institution over the credit obligation it is not certain whether the obligation actually exists and hence the counting of days past due may be suspended until the dispute is resolved. However, in order to avoid excessive use of this rule, the possibility of suspending the counting is limited to those disputes that have been introduced to a court or another formal procedure such as arbitration that will result in a legally binding ruling. It was necessary to define specific rules for leasing operations as in this case the dispute is normally between the obligor and the provider of the leasing object rather than the institution itself. In this case a well justified formal complaint is a condition for the suspension of days past due. Factoring has not been included in this provision as, if it leads to the purchase of receivables, disputes between the debtor and the seller over the product are addressed under dilution risk.

### 2.2.2 Technical past due situation

Additionally, the draft guidelines specify the definition and treatment of situations where recognition of default results from technical issues. Although the concepts 'technical default' and 'technical past due' are not specified in the CRR they are commonly used across institutions. Since the

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understanding and application of these concepts vary 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 the materiality threshold for past due exposures is to identify situations where small amounts are past due as a result of technical circumstances rather than the financial situation of the obligor and eliminate them from the estimation of risk parameters. Since the materiality threshold already serves the purpose of identification of technical delays in payments, all other cases, i.e. all exposures where the materiality threshold has been breached, have to be treated as actual defaults. Since the CRR does not envisage any additional exemptions from the days past due criterion the concept of ‘technical past due’ is defined as one of the following situations:

- The identification of default results from a data or system error of the institution, including manual errors in standardised processes but excluding wrong credit decisions.
- There is evidence that the identification of default results from failure of the payment system.
- 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 a long payment allocation process within the institution.
- In the case of factoring arrangements where the purchased receivables are recorded on the balance sheet of the institution, the materiality threshold has been breached but none of the receivables to the obligor is past due more than 30 days.

As in the above situations 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 an institution identifies such a 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.

### **2.2.3 Exposures to central governments, local authorities and public sector entities**

In order to address the specific issues related to sovereign exposures including exposures to local authorities and public sector entities and to avoid excessive recognition of defaults not reflecting actual financial difficulties of the obligor, specific treatment has been specified for this type of exposures. In many cases the repayment of such exposures is dependent by law on the completion of certain administrative procedures, which may sometimes be lengthier than initially expected. Hence it has been specified that if the delay in payments results only from these procedures and there are no other indications of a diminished financial situation of the obligor or unlikelihood to pay, default may not be recognised until any material credit obligation of such obligors to an institution is, at the maximum, 180 days past due. It has to be noted, however, that this specific treatment should only be applied in exceptional situations and institutions should make every effort to set the repayment dates in a way that includes all procedures that have to be completed before the payment and should encourage obligors to keep to the specified repayment schedule.

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## **2.2.4 Factoring and purchased receivables**

Due to specific characteristics of factoring contracts and uncertainty regarding how to apply the past due criterion to these types of contracts, clarification on these issues had to be provided in the guidelines. For that purpose a differentiation has been made between two types of factoring arrangements based on whether the underlying receivables are recognised on the balance sheet of the institution that acts as a factor. Such a differentiation is necessary as the exposure value for the purpose of own funds requirements calculation is based on the accounting value of exposures. Therefore, where individual receivables are recognised on the balance sheet, the risk weight will apply to these individual receivables; where the receivables are not actually purchased and only the exposure to the client is recorded on the balance sheet, the appropriate risk weight will apply to this exposure.

In effect it is specified that where the factor recognises on the balance sheet only the factoring account with the client, such an account should be treated as past due 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 factor recognises direct exposures to the debtors of the client, 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.

It has to be noted that purchased receivables may stem from factoring arrangements or from another type of transaction. The CRR specifies dilution risk related to purchased receivables as a type of risk distinct from the risk of default. Therefore, it has been specified that events related to dilution risk should not be considered events of default. However, a significant number of such events may indicate an increased risk of default and hence institutions should carefully analyse the reasons for such events and assess the possible indications of unlikelihood to pay.

## **2.2.5 Materiality threshold**

The concept and application of the materiality threshold have been specified in the RTS on the materiality threshold for past due exposures. However, it was necessary to give additional guidance both for institutions and their competent authorities on how to apply the conditions included in these RTS in a manner that is sufficiently transparent and prudent. In particular, it has been specified that institutions may use lower thresholds than those specified by competent authorities as additional indications of unlikelihood to pay. It has to be stressed, however, that in any case institutions are required to apply the threshold in line with the conditions specified in the RTS, especially regarding the concept and structure of the threshold and the calculation of the amount it applies to.

## **2.3 Indications of unlikelihood to pay**

### **2.3.1 Specific credit risk adjustments (SCRA)**

The guidelines provide clarification regarding the application of each indication of unlikelihood to pay as specified in Article 178(3) of the CRR. In particular, it is necessary to provide guidance on how to

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apply Article 178(3)(b), which specifies that where, as a result of a significant perceived decline in the credit quality of an obligation, the institution recognises an SCRA on any exposure of an obligor, this obligor should be classified as defaulted.

In this context it has been specified that all SCRA as specified in Article 1(5)(a) and (b) of Commission Delegated Regulation (EU) No 183/2014 on the calculation of 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 the credit quality of an obligation and hence should be treated as an indication of unlikelihood to pay.

SCRA related to incurred but not reported losses (IBNR) as specified in Article 1(5)(c) of Regulation (EU) No 183/2014 should not be considered an indication of unlikelihood to pay. These SCRA cover losses for which historical experience, adjusted on the basis of current observable data, indicates that the loss has occurred but the institution is not yet aware which individual exposure has suffered these losses. Since such SCRA are not related to a decline in the credit quality of any specific exposure they should not be considered an indication of unlikelihood to pay of a specific obligor.

It is expected that by the time of implementation of these guidelines many institutions will already apply IFRS 9 instead of current accounting standards. Since these new rules are significantly different from the currently used IAS 39 and introduce the concept of expected credit losses, which 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. Only a few exceptions from that rule have been specified and these include:

- 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 the CRR;
- the application of the materiality threshold in accordance with Article 178(2)(d) of the CRR where it is not used for the purpose of classification of exposures to Stage 3;
- technical past due situations;
- exposures to central governments, local authorities and public sector entities that are under specific treatment as described above.

If in the cases listed above the 90 days past due criterion is used for accounting purposes and credit-impaired status would be the only indication of default, such exposures may remain in non-defaulted status. These exemptions are necessary in order to make sure that the treatment of SCRA under

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IFRS 9 will not overrule the requirements and discretions specified in the CRR, which will take precedence over the accounting framework.

It has to be noted that, although Stage 2 under IFRS 9 contains exposures with potentially decreased credit quality, classification to Stage 2 should not be considered an indication of default. Therefore, exposures classified as Stage 2 will in general not be considered defaulted unless there are other indications of unlikeliness to pay.

### **2.3.2 Sale of credit obligations**

According to Article 178(3)(c) of the CRR a material credit-related economic loss related to 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 the liquidity of the institution or changes 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 to 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 a decrease in their quality or the loss on that sale is otherwise related to 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 assessed 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 the exposure should be considered an event of default.

The 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, and therefore the possible range of thresholds is limited by a cap.

### **2.3.3 Distressed restructuring**

According to Article 178(3)(d) of the CRR 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 be consistent 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 forbearance 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 a comparison between the present value of expected cash flows before the changes in the terms and conditions of the contract and the present value of expected cash flows based on the new

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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.

In this case also it is assumed that the threshold should be set by institutions but it captures mainly those situations where the change in the net present value (NPV) of the contract results from technical discounting aspects and rounding of the amounts and where the diminished obligation by forgiveness, or postponement of principal, interest or, where relevant fees should consequently not be considered material. Therefore, taking into account that Article 178(3)(d) of the CRR only refers to cases where an institution has already consented to a distressed restructuring, 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 other 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 a large balloon payment, a significantly higher repayment burden envisaged at the end of the repayment schedule and a significant grace period, as well as a situation where the exposure has been restructured multiple times.

#### **2.3.4 Bankruptcy**

Although the concept of bankruptcy is usually clearly specified in the national legal frameworks it is not always clear how the ‘similar order’ or ‘similar protection’ referred to in points (e) and (f) of Article 178(3) of the CRR should be understood. 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. It has also been specified that all types of arrangements listed in Annex A to Regulation (EU) 2015/848 have to be treated as an order or a protection similar to bankruptcy and hence as an indication of default.

#### **2.3.5 Additional indications of unlikeliness to pay**

As Article 178(3) of the CRR does not provide a comprehensive list of all situations that may indicate the 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 groups of connected clients. According to Article 172(1)(d) of the CRR, institutions are required to have appropriate policies regarding the treatment of individual obligor clients and 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 this regard as the appropriate treatment may

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depend on the legal environment in a specific jurisdiction, the business strategy of the institution and the design of the rating system used for a specific type of exposures.

As the purchase or origination of a financial asset by an institution at a material discount is treated as a potential indication of impairment for accounting purposes the treatment of such cases from a prudential perspective had to be specified in the guidelines. It has been clarified that such assets should be assessed for potential indications of unlikelihood to pay, and, importantly, that the assessment should refer to the total amount owed by the obligor regardless of the price that the institution has paid for the asset. This specification is in line with the requirement of Article 178(1) of the CRR, which relates unlikelihood to pay to the credit obligation and not to the exposure value. Default is a description of the status of the obligor and its ability to pay the obligations and not a measure of the loss of an institution; therefore, this approach was considered appropriate. At the same time alignment with accounting treatment is possible where a similar assessment is made for the purpose of classification of assets as impaired.

## 2.4 Application of the definition of default in external data

The 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 the 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 of 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 the CRR. 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 the requirements of Article 179(1)(f) of the CRR should apply and institutions should consider these circumstances by a larger margin of conservatism in the estimation of risk parameters.

## 2.5 Criteria for a return to non-defaulted status

According to Article 178(1)(a) of the CRR, 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 an assessment and that it is done in a prudent manner minimum probation periods have been specified in the guidelines. Only after an analysis of the behaviour of the obligor and of its financial situation during the probation period is it possible to assess whether the improvement of the credit quality is factual and permanent. As a result institutions may also avoid an excessive number of multiple defaults.

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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, if applicable, and no indication of unlikelihood to pay, either as specified in Article 178(3) of the CRR or as additionally specified by the institution, still applied. Institutions may use probation periods longer than 3 months and in particular may specify different lengths of probation periods for different types of exposures in order to reflect specific characteristics of these exposures. If after the probation period the institution still judges 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 relation to reclassification to non-defaulted status because the assessment of days past due is based on the modified payment arrangement and the exposure in general cannot stop being restructured until 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 latest of: i) the moment of extending the restructuring measures, ii) the moment when the exposure was classified as defaulted or iii) the end of any grace period included in the restructuring arrangements. Additionally, this period should not be shorter than the period during which a 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 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 an institution would have a limited proportion of obligors who default soon after returning to non-defaulted status. The analysis of changes in the status of obligors or facilities should in particular be taken into account for the purpose of specifying the length of the relevant probation periods.

## 2.6 Consistency of the application of the definition of default

In order to allow the integration of the definition of default into 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 and consistent with 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 unlikelihood to pay specific for certain types of exposures.
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Nevertheless, default of an obligor should also be identified consistently by the institution with regard to all exposures of this obligor in all relevant IT systems in all legal entities within the group and in all 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 if 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 to provide evidence that there are no or a very limited number of common clients of different relevant entities within a group.

## 2.7 Application of the definition of default for retail exposures

### 2.7.1 Level of application of the definition of default

According to Article 178(1) of the CRR the definition of default may be applied at the level of an individual credit facility only in the case of retail exposures. As retail exposures are defined differently for the IRB Approach 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 an individual facility for retail exposures as defined in Article 147(5) of the CRR. Additionally, the definition of default may be applied at individual facility level for purchased corporate receivables treated as retail exposures in accordance with Article 153(6) of the CRR. Institutions that use the Standardised Approach may apply the definition of default at the level of an individual facility for all exposures that meet the criteria specified in Article 123 of the CRR even if some of those exposures, for example mortgage loans, 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 the internal risk management practices of the institution. However, if an institution decided to use different levels of application of the definition of default for different types of retail exposures, the requirements of the CRR regarding 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 an obligor are assessed at the individual facility level, default on one of these exposures would not result in default of all the obligor's exposures. In order to avoid such a situation it is proposed that where institutions decide to use different levels of application of the definition of default for different types of retail exposures they should provide evidence that there are no or a very limited number of situations where the same clients are subject to different definitions of default at different levels of application.

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## 2.7.2 Pulling effect

In the case of institutions that decide to apply the definition of default at the level of an individual credit facility there is 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 the total credit obligations of an obligor that indicates when all exposures of an obligor should be considered defaulted.

Such an additional indication of unlikeliness to pay may have the advantage of aligning 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 a threshold of 20% or lower consistency with the definition of non-performing exposures will be maintained because all defaulted exposures have to be reported as non-performing.

## 2.7.3 Materiality threshold for joint exposures

Where an institution decides to apply the definition of default at the obligor level the treatment of joint exposures, i.e. exposures to a group of individual obligors, has to be specified. In order to ensure harmonised application of the default definition at the obligor level it was necessary to specify the general principles with regard to the treatment of joint credit obligations in the guidelines.

On the one hand, if any of the indications of default specified in Article 178(1) of the CRR occurs on a joint credit obligation of two or more obligors all other joint credit obligations of the same set of obligors and all individual exposures to those obligors should be considered defaulted. Exceptions from this rule have been specified in order to account for situations where the delay in payment of a joint credit obligation results from a dispute between the individual obligors and where a joint credit obligation is an immaterial part of the total obligations of an individual obligor. Moreover, the contagious effect of this default should not automatically spread to other joint credit obligations of individual obligors with other individuals or entities that are not involved in the exposure that has initially been defaulted.

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

In order to operationalise the above rules it has to be further specified how the materiality threshold should be applied in the case of joint exposures. Therefore, it has been clarified that for the purpose

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of application of 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.

## 2.8 Documentation, internal policies and risk management processes

### 2.8.1 Documentation

In order to ensure that the default definition is specified correctly and applied consistently to relevant types of exposures it has been specified in the guidelines that the documentation related to the application of the definition of default should include a detailed description of the operationalisation 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 default are likely to result in structural breaks in historical data 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.

### 2.8.2 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 by it, and by senior management in line with Article 189 of the CRR. Furthermore, in order to provide clarification on the so-called 'use test' requirements specified in Article 144 of the CRR it has been specified 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 the 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 the CRR.

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## 3. Draft guidelines

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EBA/GL/2016/07

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28/09/2016

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## Guidelines

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

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# 1. Compliance and reporting obligations

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## Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010<sup>1</sup>. 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](mailto: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).

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<sup>1</sup> 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

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### 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.
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## 3. Implementation

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### Date of application

10. These guidelines apply from 1 January 2021, 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<sup>2</sup> in order to incorporate these guidelines by the deadline referred to in paragraph 10, should agree with their competent

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<sup>2</sup> OJ L 148, 20.5.2014, p. 36.



authorities the final deadline for submitting the application for the approval of changes in the definition of default.

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 1 January 2021.

# 4. Past due criterion in the identification of default

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## Counting of days past due

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. 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.
  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 unlikelihood 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
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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. Where the repayment of the obligation is the subject of a dispute between the obligor and the institution, the counting of days past due may be suspended until the dispute is resolved, where at least one of the following conditions is met:
    - (a) the dispute between the obligor and the institution over the existence or amount of the credit obligation has been introduced to a court or another formal procedure performed by a dedicated external body that results in a binding ruling in accordance with the applicable legal framework in the relevant jurisdiction;
    - (b) in the specific case of leasing, a formal complaint has been directed to the institution about the object of the contract and the merit of the complaint has been confirmed by independent internal audit, internal validation or another comparable independent auditing unit.
  20. Where the obligor changes due to an event such as a merger or acquisition of the obligor or any other similar transaction, the counting of days past due should start from the moment a different person or entity becomes obliged to pay the obligation. The counting of days past due is, instead, unaffected by a change in the obligor's name.
  21. The calculation of 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 performed with a frequency allowing timely identification of default. Institutions should ensure that the information about the days past due and default is up-to-date whenever it's being used for decision making, internal risk management, internal or external reporting and the own funds requirements calculation processes. Where institutions 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.
  22. 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 either of the following conditions is met:
    - (a) the exposures are eligible as retail exposures and the institution applies the default definition at individual credit facility level;
    - (b) a so called 'technical past due situation' is considered to have occurred, in accordance with paragraph 23.
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## Technical past due situation

23. A technical past due situation should only be considered to have occurred in any of the following cases:

- (a) where an institution identifies that the defaulted status was a result of data or system error of the institution, including manual errors of standardised processes but excluding wrong credit decisions;
- (b) where an institution identifies that the defaulted status was a result of the non-execution, defective or late execution of the payment transaction ordered by the obligor or where there is evidence that the payment was unsuccessful due to the failure of the payment system;
- (c) 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;
- (d) in the specific case of factoring arrangements where the purchased receivables are recorded on the balance sheet of the institution and the materiality threshold set by the competent authority in accordance with point (d) of Article 178(2) of Regulation (EU) No 575/2013 is breached but none of the receivables to the obligor is past due more than 30 days.

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

In the case of institutions that use the IRB Approach, technical past due situations should be removed from the reference data set of defaulted exposures for the purpose of estimation of risk parameters.

## Exposures to central governments, local authorities and public sector entities

25. Institutions may apply specific treatment for exposures to central governments, local authorities and public sector entities where all of the following conditions are met:

- (a) the contract is related to the supply of goods or services, where the administrative procedures require certain controls related to the execution of the contract before the payment can be made; this applies in particular to factoring exposures or similar types of arrangements but does not apply to instruments such as bonds;



- (b) apart from the delay in payment no other indications of unlikelihood to pay as specified in accordance with Article 178(1)(a) and 178(3) of Regulation (EU) No 575/2013 and these guidelines apply, the financial situation of the obligor is sound and there are no reasonable concerns that the obligation might not be paid in full, including any overdue interest where relevant;
  - (c) the obligation is past due not longer than 180 days.
26. Institutions that decide to apply the specific treatment referred to in paragraph 25 should apply all of the following:
- (a) these exposures should not be included in the calculation of the materiality threshold for other exposures to this obligor;
  - (b) they should not be considered as defaults in the sense of Article 178 of Regulation (EU) No 575/2013;
  - (c) they should be clearly documented as exposures subject to the specific treatment.

## Specific provisions applicable to factoring and purchased receivables

27. Where there are factoring arrangements whereby the ceded receivables are not recognised on the balance sheet of 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 materiality threshold set by the competent authority in accordance with point (d) of Article 178(2) of Regulation (EU) No 575/2013;
  - (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 materiality threshold set by the competent authority in accordance with point (d) of Article 178(2) of Regulation (EU) No 575/2013.
28. Where there are factoring arrangements where the purchased receivables are recognised on the balance sheet of 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
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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.

29. Where the institution recognises events related to dilution risk of purchased receivables as defined in point (53) of Article 4(1) of Regulation (EU) No 575/2013, these events should not be considered as leading to the default of the obligor. Where the amount of receivable has been reduced as a result of events related to dilution risk such as discounts, deductions, netting or credit notes issued by the seller the reduced amount of receivable should be included in the calculation of days past due. Where there is a dispute between the obligor and the seller and such event is recognised as related to dilution risk the counting of days past due should be suspended until the dispute is resolved.
30. Events recognised as related to dilution risk and hence excluded from the identification of default should be included in the calculation of own funds requirements or internal capital for dilution risk. Where institutions recognise significant number of events related to dilution risk, they should analyse and document the reasons for such events and assess the possible indications of unlikelihood to pay, in accordance with Articles 178(1) and (3) of Regulation (EU) No 575/2013 and Section 5 of these guidelines.
31. Where the obligor has not been adequately informed about the cession of the receivable by the factor's client and the institution has evidence that the payment for the receivable has been made to the client, the institution should not consider the receivable to be past due. Where the obligor has been adequately informed about the cession of the receivable but has nevertheless made the payment to the client, the institution should continue counting the days past due according to the conditions of the receivable.
32. In the specific case of undisclosed factoring arrangements, where the obligors are not informed about the cession of the receivables but the purchased receivables are recognised on the balance sheet of the factor, the counting of days past due should commence from the moment agreed with the client when the payments made by the obligors should be transferred from the client to the factor.

## Setting the materiality threshold

33. Competent authorities should notify the EBA of the levels of the materiality thresholds that they set in their respective jurisdiction in accordance with point (d) of Article 178(2) of Regulation (EU) No 575/2013. After the entry into force of the regulatory technical standards developed in accordance with Article 178(6) of Regulation (EU) No 575/2013, where competent authorities set the relative component of the materiality threshold at a level different than the 1% referred to in those regulatory technical standards, they should provide the justification for this different level of the threshold to the EBA.
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34. Institutions should apply the materiality threshold for past due credit obligations set by their competent authorities as referred to in point (d) of Article 178(2) of Regulation (EU) No 575/2013. Institutions may identify defaults on the basis of a lower threshold if they can demonstrate that this lower threshold is a relevant indication of unlikelihood to pay and does not lead to an excessive number of defaults that return to non-defaulted status shortly after being recognised as defaulted or decrease of capital requirements. In this case institutions should record in their databases the information on the trigger of default as an additional specified indication of unlikelihood to pay.

## 5. Indications of unlikelihood to pay

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### Non-accrued status

35. For the purposes of unlikelihood to pay as referred to in point (a) of Article 178(3) of Regulation (EU) No 575/2013, institutions should consider that an obligor is unlikely to pay where interest related to credit obligations is no longer recognised in the income statement of the institution due to the decrease of the credit quality of the obligation.

### Specific credit risk adjustments (SCRA)

36. For the purposes of unlikelihood to pay as referred to in point (b) of Article 178(3) of Regulation (EU) No 575/2013, all of the following specific credit risk adjustments (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 unlikelihood 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.
37. 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 unlikelihood to pay of a specific obligor.
38. Where the institution treats an exposure as impaired such a situation should be considered an additional indication of unlikelihood 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
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reported losses exposures are recognised as impaired, these situations should not be treated as an indication of unlikeliness to pay.

39. 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, published by the IASB in July 2014, such exposure should be considered defaulted, except where the exposure has been considered credit-impaired 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 recognition of credit-impairment;
  - (b) the materiality threshold referred to in Article 178(2)(d) of Regulation (EU) No 575/2013 has not been breached;
  - (c) the exposure has been recognised as a technical past due situation in accordance with paragraph 23;
  - (d) the exposure meets the conditions of paragraph 25.
40. Where the institution uses both IFRS 9 and another accounting framework it should choose whether to classify exposures as defaulted in accordance with paragraphs 36 to 38 or in accordance with paragraph 39. Once this choice is made it should be applied consistently over time.

## Sale of the credit obligation

41. 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 to the sale of credit obligations, in accordance with the following paragraphs. Transactions of traditional securitisation with significant risk transfer and any intragroup sales of credit obligations should be considered sale of credit obligations.
42. 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. Institutions may, in particular, consider the loss on the sale of credit obligations as non-credit related where the assets subject to the sale are publicly traded assets and measured at fair value.
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43. Where, however, the loss on the sale of credit obligations is related to the credit quality of the obligations themselves, 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.
44. 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.

45. 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 44. Where the economic loss is higher than this threshold they should consider the credit obligations defaulted.
  46. 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.
  47. 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.
  48. 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 44 is
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breached, all credit obligations within this portfolio should be treated as defaulted at the moment of the sale.

## Distressed restructuring

49. 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<sup>3</sup> as amended by Commission Implementing Regulation (EU) 2015/227<sup>4</sup>.
50. 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 forbore exposures, the obligor should be classified as defaulted only where the relevant forbearance measures are likely to result in a diminished financial obligation.
51. 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<sub>0</sub>* is net present value of cash flows (including unpaid interest and fees) expected under contractual obligations before the changes in terms and conditions of the contract discounted using the customer's original effective interest rate;

*NPV<sub>1</sub>* is net present value of the cash flows expected based on the new arrangement discounted using the customer's original effective interest rate.

52. 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 51. Where the diminished financial obligation is higher than this threshold, the exposures should be considered defaulted.

<sup>3</sup> OJ L 191, 28.6.2014, p. 1.

<sup>4</sup> OJ L 48, 20.2.2015, p. 1.



53. 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;
  - (d) the exposures to the obligor have been subject to distressed restructuring more than once.
54. 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.
55. 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

56. 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 in their internal policies what type of arrangement is treated as an order or as a protection similar to bankruptcy, taking into account all relevant legal frameworks as well as the following typical characteristics of such protection:
- (a) the protection scheme encompasses all creditors or all creditors with unsecured claims;
  - (b) the terms and conditions of the protection scheme are approved by the court or other relevant public authority;
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- (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.

57. Institutions should treat all arrangements listed in Annex A to Regulation (EU) 2015/848<sup>5</sup> as an order or as a protection similar to bankruptcy.

## Other indications of unlikeliness to pay

58. 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.
59. 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;

<sup>5</sup> Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (OJ L 141, 5.6.2015, p. 19).

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- (g) 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;
  - (h) 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.
60. 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 unlikelihood 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.
61. When specifying the criteria for unlikelihood 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 unlikelihood to pay of all other entities within this group on a case-by-case basis.
62. Where a financial asset was purchased or originated by an institution at a material discount institutions should assess whether that discount reflects the deteriorated credit quality of the obligor and whether there are any indications of default in accordance with these guidelines. The assessment of unlikelihood to pay should refer to the total amount owed by the obligor regardless of the price that the institution has paid for the asset. This assessment may be based on the due diligence performed before the purchase of the asset or on the analysis
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performed for the accounting purposes in order to determine whether the asset is credit-impaired.

63. 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 unlikelihood to pay.

## Governance processes regarding unlikelihood to pay

64. 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 unlikelihood to pay as laid down in Article 178(3) of Regulation (EU) No 575/2013 and all other indications of unlikelihood 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.
65. With regard to each indication of unlikelihood 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

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66. 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.
67. 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
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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.

68. For each difference identified in the definition of default resulting from the assessment of paragraph 67, 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,

69. Regarding the totality of the differences identified in the definition of default resulting from the assessment of paragraph 67 and taking into account the adjustments performed in accordance with point (b) of paragraph 68, 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.

70. Where the assessment of paragraph 67 identifies differences in the definition of default which the process of paragraph 68 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

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### Minimum conditions for reclassification to a non-defaulted status

71. For the purposes of the application of Article 178(5) of Regulation (EU) 575/2013, except for situations referred to in paragraph 72, 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
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referred to in Articles 178(1)(b) and 178(3) of Regulation (EU) No 575/2013 cease to be 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.

Institutions may apply the period referred to in point (a) to all exposures or apply different periods for different types of exposures.

72. For the purposes of the application of Article 178(5) of Regulation (EU) 575/2013, and where distressed restructuring according to paragraph 49 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.

73. 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;
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- (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 unlikelihood to pay as specified in Article 178(3) of Regulation (EU) No 575/2013 or any additional indications of unlikelihood 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.

74. Where the obligor changes due to an event such as a merger or acquisition of the obligor or any other similar transaction, the institution should not apply paragraph 73(a). Where the obligor's name changes, instead, institutions should apply that paragraph.

## Monitoring of the effectiveness of the policy

75. 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).

76. Institutions should monitor on a regular basis the effectiveness of their policies mentioned in paragraph 75, 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.
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77. 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.
78. 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 71 and 72. 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

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### Overview

79. 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 80 to 82 or for retail exposures in accordance with paragraphs 92 to 94;
  - (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 83 to 85;

### Consistent identification of default of a single obligor

80. For the purposes of point (a) of paragraph 79, 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.
81. 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,
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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.

82. 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

83. For the purposes of point (b) of paragraph 79, 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) of 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 unlikelihood to pay specific for certain legal entities, geographical locations or types of exposures.
84. For the purposes of point (b)(ii) of paragraph 79, and where different definitions of default are applied either across types of exposures in accordance with paragraph 83, 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.
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85. 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

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### Level of application of the default definition for retail exposures

86. 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.
87. 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.
88. 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.
89. Where institutions decide to use different levels of application of the definition of default for different types of retail exposures, according to paragraph 88, 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.
90. 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
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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 unlikelihood to pay considerations, as provided further in paragraphs 92 to 94.

91. 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 unlikelihood to pay considerations, as provided further in paragraphs 92 to 94.

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

92. 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 unlikelihood 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.
  93. Institutions should consider also other indications of unlikelihood to pay and specify, in line with their internal policies and procedures, which indications of unlikelihood to pay reflect the overall situation of an obligor rather than that of the exposure. Where such other indications of unlikelihood to pay occur, all exposures to the obligor should be considered defaulted regardless of the level of application of the definition of default.
  94. 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.
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## Application of the definition of default for retail exposures at the obligor level

95. 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.
96. 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.
97. 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, unless they can justify that the recognition of default on individual exposures is not appropriate because at least one of the following conditions apply:
- (a) the delay in payment of a joint credit obligation results from a dispute between the individual obligors participating in the joint credit obligation that has been introduced to a court or another formal procedure performed by a dedicated external body that results in a binding ruling in accordance with the applicable legal framework in the relevant jurisdiction, and there is no concern about the financial situation of the individual obligors;
  - (b) a joint credit obligation is an immaterial part of the total obligations of an individual obligor.
98. The default of a joint credit obligation 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 unlikelihood to pay with regard to the other joint credit obligations.
99. 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 unlikelihood to pay related with the default of one of the obligors. In any case,
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where all individual obligors have a defaulted status, their joint credit obligation should automatically also be considered defaulted.

100. 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 unlikelihood 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 unlikelihood to pay occur also on the other joint credit obligations with third parties.
  101. 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 unlikelihood to pay with regard to their individual obligations.
  102. 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.
  103. 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.
  104. 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
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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 unless any of the conditions specified in paragraph 97 is met.

105. 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.

## 10. Documentation, internal policies and risk management processes

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### Timeliness of the identification of default

106. 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.
107. 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 49 to 55.
108. 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
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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

109. 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.
110. For the purposes of point (a) of paragraph 109, 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.
111. For the purposes of point (b) of paragraph 109, 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.
112. For the purposes of paragraphs 110 and 111, 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.
113. For the purposes of point (c) of paragraph 109, 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;
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- (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

114. 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 106 to 108; 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.
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## 4. Accompanying documents

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### 4.1 Impact assessment

#### A. Problem identification

Under Article 178(7) of the CRR, the EBA is required to develop guidelines on the application of the definition of default (GL).

The primary problem that the GL 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 unlikelihood to pay, criteria for reclassification of an obligor from default to non-defaulted status and the use of technical defaults. The lack of a common and consistent application of the definition of default may further lead to incomparability of IRB risk parameters and own funds requirements under both the IRB Approach and the Standardised Approach. This situation would create an uneven playing field across Member States and institutions.

#### B. Policy objectives

The objective of the GL is to establish convergence of institutions' practices and supervisory practices regarding the application of the definition of default. The GL are complementary to the RTS on the materiality threshold for credit obligations past due under Article 178(6) of Regulation (EU) No 575/2013 (RTS on the materiality threshold) and specify indications and criteria for the application of the definition of default. Harmonisation of the current practices, which 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 of complying with different regulatory frameworks.

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

- past due criterion as an indication of default;
  - indications of unlikelihood to pay;
  - return to non-defaulted status;
  - the application of the definition of default for retail exposures;
  - the application of the definition of default in external data.
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### C. Baseline scenario

The EBA conducted a qualitative and quantitative impact study (QIS) to assess the impact of the regulatory proposals to harmonise the definition of default proposed in consultation papers on the GL and the RTS on the materiality threshold. A total of 72 institutions participated in the study. Detailed results of the QIS are presented in a report on the results of the data collection exercise on the proposed regulatory changes for a common EU approach to the definition of default (QIS report) published alongside these GL on the EBA website.

The QIS contains two parts: a qualitative questionnaire to gather information on institutions' current practices and a quantitative survey aimed at quantifying the impact of the proposed technical options around the definition of default. The baseline information from the qualitative questionnaire is the benchmark for assessing the potential costs and benefits that European institutions will be subject to under the technical options. In other words, if the current practices of the institutions are the same as or similar to the elements that are specified in the GL, the expected costs will be lower than if the current practices are very different from the practices resulting from the policy decisions taken under the GL.

The results of the QIS confirm that substantial variability exists in the approaches taken across institutions in most of the areas related to the definition of default. The quantitative part of the report reinforces the conclusion that differences in the definitions of default used by institutions appear to be a driver of RWA variability.

Section 2 of the QIS report presents an overview of the current practices across institutions in relation to the technical options considered in the consultation paper on the GL. Below, the current practices observed for each technical option are compared with the provisions specified in the GL.

Section 2.2 of the QIS report shows that more than half of the institutions apply a single default definition across the group; in the other institutions, the main reasons behind the use of various default definitions, in line with paragraph 83 of the GL, may stem from different materiality thresholds or different counting of days past due for retail and non-retail exposures.

Section 2.3 of the QIS report shows that institutions are heterogeneous in their application of the definition of default for retail exposures. Institutions are split between those which apply the definition of default at the obligor level and those which apply the definition of default at the facility level or at both the facility and the obligor level. The choice in that regard is granted by Article 178(1) of the CRR. Also, the use of different levels of application of the definition of default for certain retail portfolios, under certain conditions, is in line with the requirements included in the GL. Among those institutions applying the definition of default at the facility level almost three quarters do not apply the pulling effect for the purpose of default identification, but the GL also leave it to institutions to assess whether the application of the pulling effect is appropriate and include it only as an optional indication of unlikeness to pay. The QIS results show, moreover, a heterogeneous use of contagion rules where the definition of default is applied at the obligor

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level. Almost a third of the institutions do not have a contagion rule in place and the remaining institutions apply very specific contagion rules. Such specific rules have been specified in the GL.

Section 2.4 of the QIS report shows that more than half of the institutions either do not have a definition of technical past due situations in place or recognise technical default on a case-by-case basis. The majority of institutions which have a definition for technical defaults in place use a definition that is in line with the one proposed in the GL.

More than a third of the institutions do not consider specific credit risk adjustments (SCRA) resulting from a perceived decline in the credit quality of an obligation as an indication of unlikeliness to pay, as Section 2.7 of the QIS report shows. Moreover, around 20% of the institutions reported using the impairment of an exposure as a potential trigger for default, and they are split between those that consider this regardless of whether there are any SCRA assigned, in line with the GL, and those which instead consider impairment only if SCRA are assigned.

Section 2.8 of the QIS report shows that there are greatly differing interpretations of distressed restructuring as an indication of unlikeliness to pay, as referred to in point (d) of Article 178(3) of the CRR. In half of the institutions distressed restructuring triggers default only if it leads to a diminished financial obligation, and in another 20% of the institutions it triggers default with no other conditions applied. Only around 20% of those institutions use a quantitative threshold related to distressed restructuring, but these thresholds follow a different concept from that specified in the GL and use as a reference figure the exposure value rather than a measure of loss.

Regarding the sale of credit obligations the results of the qualitative part of the QIS are limited. Section 2.9 of the QIS report shows that the requirements set out in the GL will not affect the majority of the institutions participating in the QIS, which claim that normally they do not sell credit obligations. The remaining institutions sell credit obligations, but only occasionally, and only 20% of them use a quantitative threshold for evaluating the materiality of the credit-related economic loss associated with the sale.

Section 2.10 of the QIS report shows that the types of other indications of unlikeliness to pay used are generally in line with those proposed in the GL for almost half of the institutions participating in the QIS. Other triggers of default mentioned relate to the counting of days past due, extrajudicial procedures against the obligor or enforcement procedures performed by the institution on the obligor. However, in accordance with the GL, institutions will retain flexibility in specifying the additional indications of unlikeliness to pay that are appropriate for specific circumstances and types of exposures.

Finally, Section 2.11 of the QIS report shows that probation periods before a return to non-defaulted status, for exposures defaulted due to either the days past due criterion or distressed restructuring, is the area where the greatest variability of practices is observed. As a consequence, most of the practices observed differ from the requirements set out in the GL. The qualitative analysis shows that around half of the institutions apply probation periods at least to

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some extent, while the other half do not use probation periods at all, or only for distressed restructuring. In those cases where a probation period is used, half of the institutions reclassify obligors automatically to non-defaulted status after the end of the period and half only after a case-by-case assessment. In addition to this, a wide range of practices is observed with regard to both the starting point and the length of the probation period.

The length of the probation period in use ranges from 1 month to 1 year for exposures defaulted due to the past due criterion, with around half of the institutions using a probation period of 3 months or more. For exposures under distressed restructuring the length of the probation period in use ranges from 3 months to 1 year, with almost half of the institutions using the minimum probation period of 1 year prescribed in the GL.

In the case of exposures defaulted due to the past due criterion 43% of the institutions link the start of the probation period to when the default triggers no longer apply, as prescribed in the GL. For exposures under distressed restructuring only 4% of the institutions link the start of the probation period to the latest event between the start of the restructuring measures and the default event, largely in line with what is prescribed in the GL. The most common approach (used by 33% of the institutions) is letting the probation period start when the restructuring measures are applied without checking whether this date is prior to or after the date of default or the end of any grace period.

#### D. Options considered

This section presents an assessment of the technical options considered in the GL. For each option, the potential advantages and disadvantages together with the potential costs and benefits are discussed.

##### 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 GL require that if an institution decides to use different levels of application of the definition of default for different types of retail exposures the scope of application of each definition of default should be clearly specified. In addition to this, the GL considered:

- a. a requirement to use the same level of application across all retail portfolios of the institution, parent undertaking and any of its subsidiaries;
  - b. the possibility of using different levels of application of the definition of default for certain retail portfolios only where there are no or a limited number of common clients between those portfolios (i.e. the number of common clients is kept to a strict minimum); and
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- c. the possibility of using 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 a 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 with full flexibility to adjust the level of application of the definition of default to internal risk management practices; however, it may lead to a 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 may be defaulted whereas other exposures remain in 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 a level 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 in that where the definition of default is applied at the obligor level all exposures of an obligor are defaulted at the same time. Under option b costs may be incurred due to routine monitoring of the number of common clients between portfolios. However, the benefits are expected to exceed the costs. Therefore, the preferred option is option b.

### Treatment of the 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 to 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 to the threshold in terms of a percentage of the 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 the obligor are classified as non-performing.

The qualitative analysis assessed whether the GL should introduce requirements related to the pulling effect in the application of the definition of default. The options included:

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

Option a suggests no pulling effect provision in the GL. A major advantage of the option is that the possible contagion of default between the exposures of an obligor may be implemented fully in line with 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 that the institutions specify the threshold for the pulling effect. In this way, institutions may be able to set their thresholds at the optimum level for their risk management systems. Major disadvantages of this option are, again, the lack of harmonisation and possible divergence from the ITS on supervisory reporting.

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

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

According to the results of the QIS almost three quarters of the institutions do not apply the pulling effect for the purpose of default identification. Taking into account this evidence together with the considerations related to the excessive recognition of zero-loss defaults and possible future changes in the supervisory reporting framework, it was decided that the pulling effect should not be introduced as an obligatory requirement for the purpose of the definition of default in the prudential framework; therefore, the preferred option is option a. Nevertheless, some institutions might still see default of some of exposures to an obligor as an indication of unlikelihood to pay for the remaining exposures to this obligor and might want to align the treatment of those exposures for prudential and reporting purposes. Therefore, it is proposed that where institutions consider it appropriate they may define an additional indication of unlikelihood to pay that will reflect the principle of the pulling effect.

### Definition of technical past due situations

The concept of so-called 'technical past due situations', often called 'technical defaults', has not been specified in the CRR. However, this concept is commonly used across banks, although its meaning and application vary significantly. The main purpose of the RTS on the materiality

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threshold is to identify 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 purpose of identification of technical delays in payments, all exposures where the materiality threshold has been breached should be treated as actual defaults.

The qualitative analysis assessed whether the GL should introduce a precise definition of 'technical past due situation' or 'technical default' in order to ensure harmonised application of the definition of default. The assessment included the following options:

- a. no definition of technical default;
- b. technical default referring to various non-credit-related reasons for delays in payments;
- c. technical default specified as a situation where the default event has not really occurred, as default identification was a result of certain errors or inefficiencies in data, IT systems or processes;
- d. technical default specified as in option c but with an additional clarification for factoring arrangements where the purchased receivables are recorded on the balance sheet of the institution; in this case, technical default would be specified as a situation where the materiality threshold is breached but none of the receivables is past due more than 30 days;
- e. technical default specified as a situation where an exposure is past due and 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 varying practices are currently observed, not including a provision on the definition of technical past due situations (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 for the estimation of risk parameters.

Option b allows the possibility of accounting for the specific situation of each obligor, i.e. non-credit-related reasons for delays in payments, assuming that it would be possible to define these situations in a precise and accurate manner. However, this option may result in actual defaults being overlooked and does not achieve full compliance with the CRR requirements. Also, under this option harmonisation of approaches would not be achieved as the assessment of non-credit-related situations would involve subjective judgement 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 concept of technical default. It is a simple and unambiguous definition that allows harmonised implementation. It also allows full compliance

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with the CRR requirements, although defaults may include cases where delays in payments result from non-credit-risk-related events.

Option d extends option c taking into account the feedback received during the consultation period. Due to the specific characteristics of factoring arrangements, where an institution may have many receivables towards one debtor which are frequently replaced, it is possible that the past due criterion might be breached, although the client pays the obligations regularly, by some minor delay. In order to avoid unintended consequences for the factoring industry, institutions should be allowed to consider technical past due situations cases where the materiality threshold is breached by purchased receivables that are recorded on the balance sheet of the institution if none of the receivables is past due by more than 30 days.

Finally, option e suggests that technical default could be defined as a situation where an exposure is past due and the materiality threshold has not been breached. This is also a simple and unambiguous definition that allows harmonised 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 payments over the materiality threshold should only be treated as a backstop, i.e. the latest possible moment for the identification of default.

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

### Exposures to central governments, local authorities and public sector entities

Exposures to central governments, local authorities and public sector entities are often characterised by lengthy administrative procedures related to repayment processes, which may lead to these counterparties meeting their financial obligations with delay. As many respondents in the consultation process requested a specific treatment for these exposures considering the non-credit-risk nature of such delays in payment, this was taken into account in the specification of the final GL. The following options were considered:

- a. the possibility of classifying these exposures as technical past due situations with full flexibility to apply expert judgement in assessing whether the delay in payment results from technical or credit-related reasons;
- b. the possibility of classifying these exposures as technical past due situations under specific, objective conditions;
- c. including in the GL a specific treatment for these exposures, including criteria for the scope of application of this specific treatment and monitoring requirements;
- d. applying the same general treatment as for all other exposures.

Option a suggests that institutions would be allowed to treat a delay in payment on certain exposures as a technical past due situation where the nature of the delay in payment would not be credit-risk related. However, the flexibility allowed under this option to apply expert

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judgement would not grant sufficient objectivity in recognising a technical past due situation and as a result the comparability of the definition of default for these types of obligors would be compromised.

Option b extends option a by specifying objective limiting criteria for including delays in payment on these exposures in the definition of technical past due situations. Despite some objective criteria introduced under this option this is still inconsistent with the general understanding of the concept of technical past due situations; these should be limited to cases where the material delay in payment has not occurred in reality, although the exposures under consideration are in fact objectively past due.

Option c proposes a specific treatment for these exposures under the rationale that these counterparties ordinarily meet their financial obligations, although sometimes with delay. The solution proposed under this option takes into account specific circumstances in some jurisdictions characterised by lengthy administrative procedures but at the same time is sufficiently strict and objective. The criteria include in particular a backstop of 180 days past due as well as documentation and monitoring requirements.

Under option d no exceptions are allowed and it is proposed to apply the general treatment specified in the guidelines also to these exposures, and hence full consistency across exposure classes and full alignment with CRR requirements would be achieved. However, the concerns expressed by various stakeholders would not be properly addressed. Although a situation where public sector entities are systematically late in their payments is in general not desirable this strict rule may have unintended consequences and may lead to recognition of an excessive number of defaults that would not reflect the actual financial situation of the obligors.

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

### Alignment with the supervisory reporting framework

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

- a. alignment of the definition of default with non-performing exposures;
  - b. alignment of the definition of default with non-performing exposures with the exception of the use of 180 days past due instead of 90;
  - c. non-obligatory alignment of the definition of default with non-performing exposures;
  - d. no alignment – non-performing exposures remain a broader category than defaulted exposures.
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According to the definition included in the abovementioned 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 an excessively high default rate and cure rate. In particular, where institutions are allowed to use 180 days past due instead of 90 in accordance with Article 178(1)(b) of the CRR, this discretion would in practice be overruled by the alignment with the supervisory reporting framework, which does not allow such discretion.

Option b tackles this problem by specifying an exemption. A large degree of alignment would still be achieved, the source of differences would be clear and unambiguous, and it would only apply to some institutions in the jurisdictions that decided to exercise the discretion specified in Article 178(1)(b) of the CRR.

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

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

Given the qualitative assessment of the options, the preferred option is option c. Institutions may, but are not required to, align the prudential definition of default with non-performing exposures through adequate specification of additional indications of unlikelihood to pay.

### Treatment of provisions under IFRS 9

The GL specify the conditions under which SCRA should be treated as an indication of unlikelihood to pay; clarification on the mapping of general and specific credit risk adjustments is provided in Commission Delegated Regulation (EU) No 183/2014. Although this Regulation might have to be updated to include the mapping of provisions under IFRS 9 it was considered necessary to provide clarification on the treatment of exposures classified as Stage 2 and Stage 3 under IFRS 9 in the process of default identification.

The following main options were considered:

- a. both Stage 2 and Stage 3 exposures should be automatically classified as defaulted;
  - b. all Stage 3 exposures and some Stage 2 exposures, under certain conditions, should be classified as defaulted;
  - c. Stage 3 exposures under IFRS 9 should be automatically classified as defaulted;
  - d. Stage 3 exposures under IFRS 9 should be classified as defaulted with some exceptions.
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Option a proposes that both Stage 2 and Stage 3 exposures should be classified as defaulted. The rationale for classifying Stage 2 exposures as defaulted is linked to the fact that it has been recognised that the credit risk has increased significantly, and so the indication of unlikeliness to pay prescribed in Article 178(3)(b) of the CRR applies. However, exposures classified as Stage 2 are described as not yet impaired, they are in general not yet materially past due and, additionally, at least some of them are classified to Stage 2 on a collective basis. Given these considerations it seems unduly conservative to treat all Stage 2 exposures as defaulted.

Option b assumes that some Stage 2 exposures should nevertheless be classified as defaulted, at least among those where the classification has been performed on an individual rather than a portfolio level. However, as IFRS 9 has not been implemented yet, it would be very difficult to specify objective criteria for which exposures classified as Stage 2 should be considered defaulted. In addition to that, it has not been specified yet whether Stage 2 provisions should be considered specific or general credit risk adjustments.

Option c proposes automatically classifying credit-impaired exposures under IFRS 9 (i.e. all exposures included in Stage 3) as defaulted. This rule would have the advantage of simplicity and would provide a step towards aligning the prudential and accounting frameworks. However, it may overrule some already existing requirements in the CRR, in particular where the competent authorities have replaced the 90 days past due with 180 days past due according to Article 178(1)(b) of the CRR or where the use of the materiality threshold is not allowed for accounting purposes.

Option d builds on these considerations by specifying some exceptions where Stage 3 exposures may remain in non-defaulted status. These exceptions achieve the objective of classification consistent with all other requirements specified both in the CRR and in the GL.

Taking into account the above considerations option d seems to be the most appropriate. The approach taken by the GL with regard to Stage 2 exposures is that they should be classified as defaulted if other indications of default apply but the fact that they are classified as Stage 2 should not automatically be treated as a trigger of default.

### Threshold for the sale of credit obligations

Where an institution sells credit obligations due to a decrease in their credit quality or the loss on that sale is otherwise related to 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 looked at the following options:

- a. no threshold for the materiality of the economic loss related to the sale of credit obligations – any credit-related loss leads to default;
  - b. threshold for the materiality of the economic loss defined as the difference between the outstanding amounts of the obligations and the agreed sale price;
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- c. threshold for the materiality of the economic loss defined as the difference between the outstanding amounts of the obligations and the agreed sale price, subject to a cap;
- d. threshold for the materiality of the economic loss defined by the institutions.

Not introducing a threshold would be a conservative approach to the recognition of defaults. However, the major weakness 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 would overestimate the probability of default, as the occurrence of identified defaults would increase. Setting the threshold at zero would also effectively lead to ignoring the materiality requirement in terms of the credit-related economic loss associated with the sale of a credit obligation in accordance with Article 178(3)(c) of the CRR.

Option b proposes calculating the materiality of the overall economic loss related to 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 this difference as a percentage of the outstanding amounts of the sold obligations. If the loss is higher than the threshold as specified by the institution the exposures should be considered defaulted.

The advantage of this option is that it establishes a harmonised approach with regard to the way the sales of credit obligations are assessed. On the other hand, a major disadvantage of the option is that institutions could set the thresholds at very different levels and in some cases defaults might not be recognised 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 the addition of a 5% cap (i.e. the threshold set by the institutions should not be higher than 5%). The option inherits some of the advantages of 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, the threshold, if set too low, may lead to overestimation of the probability of default and underestimation of the loss given default (as described also under option a).

Finally, option d leaves the threshold for the materiality of the economic loss to be set by the institutions. The option is fully flexible as it gives the institutions room to align with internal risk management and takes into account the perceived materiality of the economic loss. However, the option fails to establish a harmonised regulatory framework, and it may lead to non-risk-based differences in risk estimates and to underestimation of capital requirements.

Given the qualitative assessment of the options, although the QIS results show that the use of a threshold to evaluate the materiality of a credit-related economic loss is not a common practice among institutions, the preferred option is option c. However, it has to be noted that the threshold will only apply to credit-related economic losses and a certain degree of expert judgement is granted to institutions to assess whether a loss on a sale of credit obligations is credit-related.

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## Threshold for distressed restructuring

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

The policy options relate to if the GL should introduce a 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. In this regard, the following options have been considered:

- a. no threshold for the diminished financial obligation;
- b. 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 the terms and conditions of the contract;
- c. 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 the terms and conditions of the contract, subject to a cap;
- d. threshold for the diminished financial obligation to be specified by institutions.

The reasoning behind the assessment of the policy options in this field is very similar to that presented under the options related to the sale of credit obligations. Here, the preferred option is option c. In order to assess whether restructuring arrangements lead to diminished financial obligations institutions should compare the present value of the expected cash flows before the changes in the terms and conditions of the contract and the 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 this difference as a percentage of the present value of expected cash flows before the application of restructuring arrangements. If the percentage 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 cases where the change in the NPV of the contract results from technical discounting aspects and rounding of the amounts. Where, however, the diminished NPV results from a conscious decision of an institution due to the client's financial difficulties the situation should be treated as a defaults.

## Probation period for a return to non-defaulted status

Institutions should define clear criteria for 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 when it is no longer unlikely that the repayment will actually be made. The analysis considered several options for the period for assessing the financial situation of an obligor for this purpose. These options related to the probation period are:

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- 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 3 months from the moment that no specific indications of default apply;
- e. minimum probation period specified by the institutions with a minimum duration of 3 months from the moment that no specific indications of default apply, where different lengths of probation period may be applied to different types of exposures.

Both options a and b may lead to an excessive number of multiple defaults. Under option b this problem is to some extent mitigated as further delays in payment would result in the recognition of the 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 an 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 in terms of both the lengths and the starting points of probation periods.

Option d develops option c with an additional minimum requirement of 3 months and specification of the starting point. Only after that period may institutions consider that the condition specified in Article 178(1)(a) of Regulation (EU) No 575/2013 no longer continues to apply. In making this assessment institutions should take into account the behaviour of the obligor during the probation period and the financial situation of the obligor. If after the probation period the institution still judges 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 e develops option d further, clarifying that different lengths of probation periods may be applied to different types of exposures. This adds more flexibility to the framework and allows institutions to better capture the specificities of different types of exposures, as requested by the industry in the responses to the consultation paper. This flexibility seems to be a sensible way forward, while at the same time minimum criteria are set that will reduce the variability of practices observed in the results of the QIS.

Option e is a prudent approach and avoids frequent changes of status of exposures and thus an excessive number of multiple defaults. Moreover, it better addresses both the industry's feedback and the variability of practices observed in the QIS. Since it strikes a balance between harmonisation and flexibility it is selected as the preferred option.

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## Probation period and other conditions for distressed restructuring

The assessment of possible policy options is similar to the previous analysis and looks at the probation period together with other conditions for when exposures under 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 1 year for distressed restructuring specified in the GL;
- d. return to non-default possible only after full repayment of the contract subject to distressed restructuring.

Option a is operationally simple; however, it could result in identification of an excessive number of multiple defaults and does not account for specific risk related to 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 alignment with the internal risk management practices of the institutions and would probably in many cases avoid an excessive number of multiple defaults. However, it does not achieve the objective of harmonisation, and the non-risk-based differences in risk estimates may prevail.

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

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

Taking into account the above considerations the preferred option is option c.

## Frequency of counting of days past due

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

- a. not specifying the frequency of counting of days past due;
  - b. introducing a requirement to count days past due on a daily basis; and
  - c. a general specification that the frequency of calculation should allow for timely identification of default and adequate data to be used for risk management purposes; if
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the frequency is lower than daily institutions should ensure that the date of default is correctly identified.

Option a will not generate implementation costs; however, it is not adequate to achieve 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 GL may not be able to address the non-risk-based differences in the estimates of risk parameters.

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

Timely identification of default is important to make sure that accurate information is used for risk management purposes, for instance that the information on the default is available at the moment when further credit decisions are taken for the obligor. For that reason information about the default of a client should be available in the business units of the institution without undue delay and whenever information about the status of the obligor is used for any management purposes including internal or external reporting and calculation of capital requirements. Option c introduces principle-based guidance to institutions for setting the frequency of days past due. This option would not achieve full harmonisation with regard to the frequency of counting of days past due, but for the purpose of estimation of risk parameters the appropriate date of default would in any case have to be identified ensuring sufficient harmonisation in that regard. This option minimises the required modifications to IT systems and therefore does not lead to excessive operational costs.

Since what matters is the accuracy of the information used for the purpose of risk management and option c achieves this objective by setting out the principles for the timely recognition of default, as well as creating a more prudential regulatory framework with less operational cost, it is selected as the preferred option.

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

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## E. Impacts of the technical options

Under the Standardised Approach, Article 127 of the CRR 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 the SCRA. If the SCRA 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 SCRA are less than 20% of the unsecured part of the exposure value. In other words, a stricter default definition might lead to a higher level of defaulted exposures in the asset class where higher risk weights are assigned, leading to higher own funds requirements.

Under the IRB Approach the definition of default has an impact on the classification of exposures as defaulted with a PD that is equal to 100%, which therefore has an impact on the calculation of expected loss and own funds requirements, which represent the unexpected loss. Under the Foundation IRB (FIRB) Approach the risk weight of defaulted exposures is set to zero. However, the calculation of expected loss is based on a PD that is equal to 100%; therefore, it will be 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. Under 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 for defaulted exposures (LGD in-default) and best estimate of expected loss ( $EL_{BE}$ ) parameters.

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

A stricter default definition would result in relatively high default rates and relatively high PD estimates. However, not all of the identified defaults generate losses, so this could decrease the LGD estimates of the AIRB institutions.

The quantitative part of the QIS was designed to quantify the impact of the proposed technical policy options taking into account the various dimensions of impact as described above. The analysis was performed on a sample of 64 institutions (of which 22 used the SA, 32 used the IRB Approach and 10 reported on both SA and IRB exposures). These institutions account for 44% of the total of EU institutions' credit risk-weighted exposures<sup>6</sup>.

The estimation of the impact was performed by institutions on selected representative samples of specified portfolios of retail and corporate SME exposures. The representativeness of the samples selected for the analysis by the institutions may impact the accuracy of the analysis. It should also be noted that the subjectivity of institutions in interpreting and estimating the impact may affect the results of any analysis undertaken. Moreover, institutions were requested to provide their

<sup>6</sup> ECB statistics on consolidated banking data.



estimates on a best-effort basis, which could affect the accuracy of their estimates in some cases. The detailed results of the analysis are presented in Section 4 of the QIS report.

In theory, the stricter the definition of default is, the greater the number of defaults identified. A higher level of defaults generates higher expected loss and in the case of the SA the total exposure value of exposures classified to an asset class of defaulted exposures is higher. The effect on capital requirements, however, is not straightforward and depends on the method used by the institution to calculate capital requirements:

- In the case of institutions that use the SA more exposures are classified as defaulted, but on the other hand a higher rate of credit risk adjustments results in lower risk weights for defaulted exposures (100% or 150% as explained in the previous paragraphs). However, as these are the highest levels of risk weights used in most of the other exposure classes, it is reasonable to expect that the stricter the definition of default, the higher the risk-weighted exposure amounts. In other words, the stricter the default definition, the higher the level of defaulted exposures in the asset class where higher risk weights are assigned, and higher risk weights are used in the calculation of own funds requirements.
- In the case of institutions that use the FIRB Approach the risk weight of defaulted exposures is zero. However, the calculation of expected loss is based on a PD that is equal to 100%; therefore, it is much higher than if the exposure was not classified as defaulted. The stricter the default definition, the higher the expected loss. If the expected loss is not fully covered by the credit risk adjustments then the difference is deducted from own funds. Moreover, the definition of default also impacts the risk weights of non-defaulted exposures through PD estimates. A stricter default definition results in a higher default rate, higher PD estimates and higher risk weights for non-defaulted exposures.
- In the case of institutions that use the AIRB Approach the impact on capital requirements is complex. The risk weight for defaulted exposures is not zero but calculated on the basis of  $EL_{BE}$  and LGD in-default estimates, and should represent unexpected loss in the recovery process. It is not explicit whether the risk weight calculated in this way is higher or lower than the risk weight for non-defaulted exposures. This depends largely on the methodologies used by particular institutions. The definition of default also impacts the risk weights of non-defaulted exposures through PD and LGD estimates. With regard to PD it is clear that the stricter the definition is the higher are PD estimates and risk weights. In the case of LGD, however, the impact would most likely be the reverse, because a stricter definition of default might result in more defaults that would be cured within a short period of time. This effect would decrease LGD estimates and risk weights for non-defaulted exposures.

The quantitative analysis of the QIS was therefore performed separately for IRB and SA institutions. In the case of the SA the analysis was based on the expected reclassifications of exposures to and from the exposure class 'exposures in default'. In this respect, the stricter the definition of default, the higher the level of defaulted exposures in the asset class to which higher

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risk weights are assigned. For IRB institutions, on the other hand, the analysis of the impact was based on the estimated changes in five simplified risk parameters, namely default rate (DR), cure rate (CR), recovery rate (RR), proportion of defaulted assets within a given type of exposure and best estimate of expected loss for defaulted exposures ( $EL_{BE}$ ). Based on these parameters the impact on risk-weighted assets, expected loss and own funds requirements was calculated according to some simplifying assumptions.

Below, a summary of the results of the QIS is presented, in terms of estimated capital impact, for each technical option proposed in the GL.

### QIS results: technical past due situations

The scenario specified for testing the impact of the introduction of the definition of technical past due situations corresponds to the provisions included in paragraph 20 of the consultation paper on the GL. Therefore, where institutions use a broader definition of technical past due situations an increase in default rate accompanied by a possible decrease in LGD for IRB institutions could be expected. The results of the QIS confirm this expectation and Table 9 in the QIS report shows a modest increase in default rate and decrease in LGD for IRB institutions across all exposure classes under consideration. The overall impact on capital is also very modest, corresponding to an overall decrease in capital adequacy ratio of around 0.01 p.p. based on own funds (0.01 p.p. based on CET1) for the sample of SA institutions and an increase in capital adequacy ratio of around 0.018 p.p. based on own funds (0.010 p.p. based on CET1) for the sample of IRB institutions. The final GL relax the definition of technical past due situations with respect to the consultation paper, including in particular some specific wording for factoring arrangements. This would if anything reduce the impact observed in the QIS, which could be taken as a upper bound for the potential impact.

### QIS results: specific credit risk adjustments (SCRA)

The scenario specified for the purpose of the QIS corresponds to the provisions included in the GL in paragraphs 36 and 37. Thus it is based only on the currently applicable accounting standards and does not include possible changes that will be applicable after the implementation of IFRS 9. Therefore, where institutions use a stricter approach (e.g. treat incurred but not reported losses as an indication of unlikeliness to pay), those cases have been removed from the calculation of default rate unless there were other indications of unlikeliness to pay. Conversely, where on the basis of current policies some exposures that meet the conditions specified in paragraph 36 of the GL were not treated as defaulted, those cases have been added to the default rate. The latter seems to be the case for most of the institutions participating in the QIS. In fact, more than a third of the institutions do not consider SCRA an indication of unlikeliness to pay, as Section 2.7 of the QIS report shows. The results of the quantitative analysis, as presented in Table 7 in the QIS report, show a modest increase in default rate and decrease in LGD for the IRB institutions across all exposure classes taken into consideration. The overall impact on capital is very modest, corresponding to an overall decrease in capital adequacy ratio of around 0.027 p.p. based on own funds (0.026 p.p. based on CET1) for the sample of SA institutions and an increase in capital

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adequacy ratio of around 0.042 p.p. based on own funds (0.017 p.p. based on CET1) for the sample of IRB institutions.

### QIS results: sale of credit obligations

The scenario specified for the purpose of the QIS corresponds to the provisions included in the GL in paragraphs 41 to 48. One difference is that, while in the GL the threshold for evaluating the materiality of the credit-related economic loss should be set by institutions at a level not higher than 5%, and so the 5% acts as a cap for the threshold, the QIS tested exactly this upper bound. A second difference is that in the final GL additional clarification has been added on the fact that that internal sales as well as traditional securitisation with significant transfer of risk should be treated as sales of credit obligations, while in the consultation paper this was not fully clear and could have been interpreted otherwise by the institutions participating in the QIS. Considering those two differences we can interpret the results of the QIS as a lower bound for the potential impact.

The results of the QIS in the area of the sale of credit obligations are limited due to the fact that most of the institutions participating in the QIS do not sell credit obligations and even if they do they usually do not use a quantitative threshold to assess the materiality of loss. The quantitative part of the QIS confirms the observed practices, showing a very small impact in terms of capital requirements for both SA and IRB institutions (an increase in capital adequacy ratio of around 0.007 p.p. and 0.014 p.p. based on own funds, respectively).

### QIS results: probation period before a return to non-defaulted status

The scenario specified for the purpose of the QIS corresponds to the minimum probation period of 3 months, as specified in paragraph 71 of the GL. This requirement was included in the estimation of cure rate as well as in the calculation of default rate on the basis of the currently applicable treatment of multiple defaults. The qualitative section of the QIS shows that the probation period is one of the areas in which greater variability of institutions' practices is observed. For around half of the institutions, using a probation period of 3 months or more, no impact is expected. By contrast, for the remaining institutions, using a shorter probation period or mixed approaches for different types of exposures, we could expect a decrease in default rate and an increase in LGD. These expectations are confirmed by the quantitative section of the QIS, as shown in Table 6 in the QIS report for IRB institutions, where we observe a decrease in default rate and an increase in LGD in all exposure classes under consideration. The overall impact on total capital charge is quite different for SA and IRB institutions. A modest decrease in capital adequacy ratio of around 0.011 p.p. based on own funds (0.010 p.p. based on CET1) is observed for the sample of SA institutions, while a more significant decrease in capital adequacy ratio of around 0.131 p.p. based on own funds (0.104 p.p. based on CET1) is observed for the sample of IRB institutions. This is due to the interactions of probation period requirements with risk parameters, in particular cure rate and default rate. It is worth mentioning that the impact on capital observed for IRB institutions is not only more significant compared with those of the other

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technical options but also more dispersed, which is consistent with the significantly different practices among institutions observed in this area.

### QIS results: probation period for exposures subject to distressed restructuring

The scenario specified for the purpose of the QIS corresponds to the minimum probation period of 1 year starting from the latest between the moment of extending the restructuring procedure, the default event and the end of any grace period included in the restructuring arrangements, as proposed in paragraph 72 of the GL. The same considerations as for the probation period for exposures defaulted due to other criteria apply, and also here a great variability of practices is observed in the qualitative section of the QIS. For around 46% of the institutions, using a probation period of 1 year, no impact is expected. By contrast, for around 25% of the institutions, which claim to use a probation period of less than 1 year, we could expect a decrease in default rate and an increase in LGD. These two effects seem to compensate for each other and, in Table 5 in the QIS report, we observe no significant movement in the default rate in all exposure classes under consideration. LGD in general increases, although the magnitude of this increase is quite different for different exposure classes. The overall impact on capital shows a modest decrease in capital adequacy ratio of around 0.033 p.p. based on own funds (0.031 p.p. based on CET1) for the sample of SA institutions and a more significant decrease in capital adequacy ratio of around 0.115 p.p. based on own funds (0.095 p.p. based on CET1) for the sample of IRB institutions.

### QIS results: contagion effect

The scenario regarding the contagion effect specified for the purpose of the QIS corresponds to the provisions included in paragraphs 81 to 90 of the consultation paper on the GL. Contagion has been specified for the purpose of the QIS as a situation where the default of one obligor influences the default of another obligor and relates to the rules regarding the treatment of joint credit obligations and related clients in the retail exposure class. This policy option is therefore tested only for retail exposures and only by those institutions that apply the definition of default at the obligor level. Where currently the required contagion between individual and joint credit obligations is not taken into account the related exposures were added to the default rate. On the other hand, where currently stricter contagion rules are in use the affected exposures that do not meet the criteria specified in the GL were removed from the calculation of the default rate, unless there were other indications of unlikeliness to pay.

It is worth noting that, for the estimation of the impact of the contagion requirements, the QIS specified using the materiality threshold currently in use rather than the one prescribed in the RTS on the materiality threshold. Although there are clearly interactions between the two, these are intentionally not reflected here, in order to capture the pure impact of the proposed contagion rules. Table 7 in the QIS report shows a modest increase in default rate and decrease in LGD for the IRB institutions across all exposure classes under consideration. Although the qualitative section of the QIS shows a heterogeneous use of contagion rules among institutions the overall impact on capital is almost zero for both SA and IRB institutions.

### QIS results: qualitative impact assessment

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The qualitative section of the QIS provides information on the impact of some technical options which have not been tested quantitatively but where a qualitative impact assessment has been performed by the institutions. These include the use of different default definitions within an institution or a group; the level of application of the default definition for retail exposures; pulling effect; new days past due counting; and other indications of unlikeness to pay. The figures in point 2 of the appendix to the QIS report show that around 70% of the SA and IRB institutions expect no or negligible impact as a result of the abovementioned policy options. However, the proposed rules on counting of days past due are perceived to be likely to have a somewhat significant to significant impact by more than 20% of the institutions.

## F. Cost-benefit analysis

### Costs for institutions

Currently, the institutions already use certain definitions of default. In the absence of detailed guidance the baseline scenario shows that various approaches are adopted by the institutions with regard to the application of the definition of default given in the CRR. As a result, with the adoption of these GL some institutions will have to introduce some changes. These changes in the definition of default might have a 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 the definition of default will affect in particular those institutions that use the IRB approach. The risk parameters are estimated on the basis of historical data collected using certain default identification processes. The consistency of the historical data with the adequate 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 GL 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 institutions 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 SA the impact of the changes will be relatively less significant as there will be no need to adjust historical data unless the institution decides to apply for permission to use the 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 changes to the processes and possibly also IT systems used to collect the data and calculate capital requirements.

The QIS results generally show that the introduction of the harmonised definition of default proposed in the GL and in the RTS on the materiality threshold will lead to a modest increase in capital charges, corresponding to an overall reduction of capital adequacy ratios of around

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0.062 p.p. based on own funds (0.055 p.p. based on CET1) for the sample of SA institutions and of around 0.176 p.p. based on own funds (0.163 p.p. based on CET1) for the sample of IRB institutions.

It has to be stressed that the results of the quantitative part of the QIS do not capture the whole spectrum of potential impact on capital charges as only selected policy options included in the GL were tested. Other areas of the definition of default were analysed only in a qualitative manner. Moreover, the QIS did not estimate in a quantitative manner the implementation costs. These are expected to be significant for some institutions, especially those where the required changes to risk management processes, IT systems used to collect data and rating systems used for the calculation of capital requirements will be more significant.

### Costs for national supervisory authorities

According to Regulation (EU) No 529/2014 any change in the definition of default is a material change that requires the 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 to the changes in the definition of default. Granting such approvals in a timely manner might cause a significant operational burden for the national supervisors. In order to ensure efficient implementation of the changes competent authorities will have to review and agree on individual implementation plans with these institutions and later verify the timely implementation of those plans.

### 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. This will contribute to increased confidence of external stakeholders such as investors in the adequacy of the levels of capital held by institutions and in the longer term will help achieve greater stability of the institutions. Furthermore, aligning supervisory expectations in the area of default definition will contribute towards ensuring a level playing field for the institutions. Finally, similar practices applied in all jurisdictions will reduce the administrative and operational burdens for cross-border institutions of complying with different regulatory frameworks in different Member States.

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## 4.2 Views of the Banking Stakeholder Group (BSG)

### General comments

The BSG supports the initiative, which aims at harmonising supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups. The Group stresses that it is important to ensure consistency in the default definition not only between institutions but also between different regulations, including in particular the accounting framework and IFRS 9. At the same time the BSG requests that consistency with global standards should not be neglected.

The BSG considers the definition of default a very sensitive issue, where inappropriate treatment could disconnect the prudential status of the default from the economic reality of the counterparty. This would conflict with the requirement for a 'use test' incorporated in the IRB framework. Therefore, a sufficient degree of flexibility in the application of the rules is advocated, as is allowing the application of expert judgement where necessary.

The BSG points out that many of the suggested changes will require significant system changes as well as changes in the calibration and will in many cases require redevelopment of internal models. It is therefore requested that significant time is allowed for the adoption of the new regulations in order for institutions to be able to handle all necessary changes and to obtain supervisory approval for the changes made. It is also considered essential to implement the new definition of default at the same time as the review of all internal rating methodologies. One of the particular challenges for implementation mentioned by the BSG is the counting of days past due. It is suggested that in some situations identification of default at month-end only should be allowed.

### Specific issues

With regard to specific issues that the EBA consulted on, the BSG expressed the opinion that the proposed definition of technical default is too restrictive and provided a number of additional proposals for situations that should be considered technical defaults. Also, the BSG considered too restrictive the levels of the thresholds proposed for the purpose of recognition of default based on the sale of credit obligations and distressed restructuring. Furthermore, it was considered unnecessary to set fixed probation periods for return to non-defaulted status and the Group suggested that the process for recognition of when a customer is no longer in default should be up to each institution. The possibility of using expert judgement was also requested with regard to the application of the materiality threshold to joint credit obligations.

Largely in line with the EBA proposals, the BSG considered that the purchase or origination of a financial asset at a material discount should not always be treated as an indication of unlikelihood to pay. Similarly, the use of the pulling effect was not supported as it would diminish the value of applying the definition of default at the facility level and would most likely reduce the predictability of PD models.

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The BSG agreed with the proposals included in the consultation paper regarding the treatment of factoring, the level of application of the default definition for retail exposures and internal governance for banks that use the IRB Approach. The Group also agreed with the specification of the treatment of specific credit risk adjustments and welcomed the EBA's proposal to anticipate the implementation of IFRS. However, additional clarification was requested in particular regarding the exposures classified as Stage 2 in accordance with IFRS 9.



## 4.3 Feedback on the public consultation and on the opinion of the BSG

The EBA publicly consulted on the draft proposal contained in this paper.

The consultation period lasted for 4 months and ended on 22 January 2016. A total of 39 responses were received, of which 33 were published on the EBA website.

This paper presents a summary of the key points and other comments arising from the consultation, the analysis and discussion triggered by these comments and the actions taken to address them if deemed necessary.

In many cases several industry bodies made similar comments or the same body repeated its comments in response to different questions. In such cases, the comments, and the EBA's analysis, are included in the section of this paper where the EBA considers them most appropriate.

Changes to the draft guidelines have been incorporated as a result of the responses received during the public consultation.

### Summary of key issues and the EBA's response

Responses to the consultation showed general support for the effort to clarify and harmonise the definition of default in order to decrease RWA variability. Many respondents requested that in these efforts consistency should be ensured, to the extent possible, with the accounting framework and in particular with IFRS 9. In the context of IFRS 9 explicit clarification was often requested that exposures classified as Stage 2 should not be treated as defaulted.

An often repeated comment referred to the need to maintain a sufficient degree of flexibility in the application of the definition of default and to the fact that in some situations expert judgement should be allowed. The EBA agrees that the definition of default contains elements of subjective assessment of unlikelihood to pay; however, the final backstop for the recognition of default should be specified in an objective manner in order to ensure sufficient comparability across institutions.

The possibility of using expert judgement was also requested in relation to the identification of technical defaults. This was, however, not considered appropriate as, in accordance with Article 178 of the CRR, any situation that leads to a material delay in payment or unlikelihood to pay should be considered default and the concept of technical default cannot overrule this requirement. Nevertheless, many of the specific concerns expressed by the respondents were addressed in the guidelines through clarifications on the calculation of days past due, rather than through changes to the definition of technical defaults. These clarifications related in particular to the treatment of disputes over credit obligations.

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Many respondents raised specific issues relating to sovereign exposures and exposures to public sector entities, where delay in payment often results from lengthy administrative procedures rather than from financial difficulties. It was suggested that these situations should be treated as technical defaults. Instead, a specific treatment has been specified in the guidelines that applies to central governments, local authorities and public sector entities.

Mixed views were expressed in relation to certain aspects where specific questions had been asked of the industry. With regard to probation periods before reclassification of exposures from defaulted to non-defaulted status the majority of respondents did not support fixed probation periods and preferred in general to keep more flexibility in setting the probation periods for specific situations. Although it was considered by the EBA that from both a prudential and a comparability perspective it was important to specify the minimum length of probation periods, institutions have been allowed flexibility to use longer probation periods for certain types of exposures if deemed appropriate.

In many of their comments respondents requested additional clarifications on the proposed rules. This related in particular to the application of the default definition to factoring exposures, where many additional provisions have been added to the guidelines in order to provide greater clarity.

Finally, many respondents indicated that the implementation of the guidelines may be burdensome and, in the case of institutions that use the IRB Approach, the implementation will be conducted simultaneously with the broader review of IRB methodologies, and hence sufficient time for implementation is necessary. The EBA understands these concerns and envisages a phase-in approach with sufficiently long implementation periods. These expectations have been expressed in detail in the EBA's Opinion on the implementation of the regulatory review of the IRB Approach, published on 4 February 2016<sup>7</sup>.

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<sup>7</sup> <https://www.eba.europa.eu/documents/10180/1359456/EBA-Op-2016-01+Opinion+on+IRB+implementation.pdf>



## Summary of responses to the consultation and the EBA's analysis

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<b>General comments</b>			
<b>Relations with IFRS 9</b>	<p>Many respondents suggested that the Guidelines should be as consistent as possible with IFRS 9. Specific issues related to IFRS 9 that were mentioned by the respondents include in particular the following:</p> <p>a. the IFRS 9 standard uses the term '90 days and more past due' (90+) while the Consultation Paper and Article 178(1)(b) of the CRR refer to 'more than 90 days past due' (91+);</p> <p>b. given that the wording 'significant perceived decline in credit quality' as an indication of unlikelihood to pay might be misleading and wrongly equated with Stage 2 of IFRS 9, the Guidelines should clarify that classification in Stage 2 should not be considered an indication of default.</p>	<p>The EBA recognises the benefits of aligning the frameworks. However, some differences may remain where they stem from different objectives of prudential and accounting regulations or from the specific wording of primary regulations.</p> <p>a. The Guidelines have to be consistent with the wording of the CRR. It is considered a minor difference as for accounting purposes it is applied only at the reporting dates whereas for prudential purposes defaults are recognised on a daily basis. In IFRS 9, 90 days past due is a rebuttable presumption so it should be possible to use 91 days if justified by alignment with prudential practices.</p> <p>b. According to the text of the Guidelines it is clear that exposures in Stage 2 should not be automatically classified as defaulted. However, it is possible that some exposures in Stage 2 will be defaulted if there are other indications of unlikelihood to pay.</p>	No change
<b>Implementation</b>	<p>Many respondents suggested that the Guidelines should be as consistent as possible with IFRS 9 not only in terms of the content but also in terms of the time of implementation. However, several respondents requested that the implementation of the definition of default should only be required after implementing IFRS 9</p>	<p>The changes have to be implemented at the latest by the end of 2020, hence sufficient time is granted after the date of implementation of IFRS 9. However, institutions may implement the changes in a shorter timeframe. Therefore, if it is deemed appropriate, institutions may align the timeline for implementation</p>	No change



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>as it would be too burdensome to adapt both aspects simultaneously.</p> <p>In terms of implementation several respondents suggested that the new requirements should apply only prospectively and not retrospectively. Retrospective adjustment is not always possible and performing the adjustment may lead to data quality issues and to a high degree of inhomogeneity of data.</p> <p>It was also noted that the implementation will be conducted simultaneously with the broader review of IRB methodologies and hence sufficient time for implementation is necessary. A few respondents requested that a comprehensive balancing of benefits and costs should be performed of both the changes in the definition of default and the whole IRB review.</p> <p>Consistency with the amendments proposed by the BCBS is considered important to avoid a duplicated burden related to the implementation of these amendments.</p> <p>It was also proposed that the implementation of regulatory changes should not lead to penalties such as additional margin of conservatism (MoC).</p>	<p>of the Guidelines with the implementation of IFRS 9.</p> <p>The EBA's expectations with regard to the implementation of the changes, including the reference to possible retrospective adjustments in the data, have been expressed in the EBA's opinion on the implementation of the regulatory review of the IRB Approach published in February 2016. The adjustment of historical data in order to reflect the new definition of default in the estimates of risk parameters is considered a superior approach, where such an adjustment is considered possible and not unduly burdensome by competent authorities, but will not be required in all cases. The EBA's opinion reflects a holistic approach to implementation that includes not only the changes in the definition of default but also all other changes related to the regulatory review of the IRB Approach.</p> <p>A common understanding of the definition of default is considered crucial for the comparability of capital requirements under the IRB Approach.</p> <p>The necessity to apply MoC in cases where the data are less satisfactory or not representative of the current portfolio and processes stems from the requirements of the CRR and therefore cannot be overruled by the Guidelines.</p>	
<p><b>Materiality of model changes</b></p>	<p>A few respondents suggested that in the case of implementation of the regulatory changes the approach to the assessment of the materiality of model changes should be simplified and should provide more flexibility to</p>	<p>The aspects of the materiality of the changes and related approval processes are regulated by Regulation (EU) No 529/2014 and therefore the</p>	<p>No change</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	facilitate re-approval processes, especially in the SSM context.	treatment cannot be changed by the Guidelines.	
<b>Level of application</b>	A few respondents indicated that, for banks spread over a large geographical area, it is quite resource-intensive to implement some of the proposals since some information is not collected on that local level or the relevant information is not submitted to central systems. It was proposed that the group-wide default determination should consider only exposures of core subsidiaries that are involved in lending business in the narrow sense or those included in the regulatory scope of consolidation.	The application of the default of an obligor on a group-wide basis is required by Article 178(1) of the CRR. The CRR also specifies the relevant level of consolidation.  In order to address operational aspects of the application of the definition of default at a group-wide level paragraphs 81 and 82 specify situations where simplified processes may be applied.	No change
<b>National discretions</b>	Some respondents requested clarification on the application of the national discretions related to the definition of default. In particular clarification was requested regarding potential removal of national discretion to use 180 days instead of 90 days past due for certain exposures.	National discretions granted by the CRR to the competent authorities cannot be overruled by the Guidelines. Hence, competent authorities may decide that the application of 180 days past due is appropriate for the exposures specified in Article 178(1)(b) of the CRR.	No change
<b>Daily identification of defaults</b>	Daily determination of past due amounts was perceived by many respondents as overly burdensome and would significantly increase the complexity of the implementation, especially with regard to exposures such as mortgages, factoring or other retail exposures, as currently monthly checking is common in retail business. It was also mentioned that some institutions determine the default on a daily basis but the information is sent to the central database in batch form at the end of the month.	It has been clarified in the Guidelines that the timely identification of default is perceived from the perspective of the objective that up-to-date information has to be used in all relevant processes. Therefore, up-to-date information about the default of an obligor has to be available whenever it is used in any of the institution's processes. The modified text is included in paragraph 21 of the Guidelines.	Par. 21



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<b>Flexibility</b>	<p>Several respondents stated that a sufficient degree of flexibility is needed regarding the institutions' application of the unlikelihood to pay criterion and the definition of default in general. Complete standardisation of the definition of default across all EU institutions is perceived as not desirable.</p> <p>However, other respondents suggested that the Guidelines should provide clear, consistent and appropriate definitions of terms such as 'material', 'significant' or 'large' to allow a distinct identification of obligations across institutions.</p>	<p>The Guidelines set minimum standards and a common understanding of the main concepts related to the definition of default. However, institutions may recognise default earlier on the basis of expert judgement whenever they consider that the obligation will not be paid in full by the obligor without recourse to actions such as realising security.</p> <p>The clarification of terms such as 'material', 'significant' or 'large' has been proposed wherever it was considered that harmonisation is appropriate. Otherwise it is left to the expert judgement of the institutions.</p>	No change
<b>Payment allocation</b>	<p>Some respondents noted that the proposed Guidelines ignore the existence of different practices in the treatment of missed payments, i.e. how incoming cash flows after a default situation should be treated in relation to the previous instalments that are in arrears. A FIFO (first in first out) approach or a LIFO (last in first out) approach will influence a return to non-defaulted status. The harmonisation of a procedure for these cases is considered very important and should be included in the EBA's final Guidelines.</p> <p>Some respondents suggested that the application of a FIFO approach should be required while others preferred a LIFO approach.</p>	<p>It was decided not to prescribe any specific method for the allocation of payments. These aspects are often regulated by national laws as well as specific contracts with the clients. Apart from FIFO or LIFO there are also many different approaches that may be based, for instance, on specific credit products or on the interest rates related to different credit facilities of an obligor.</p> <p>The variability in the identification of default resulting from payment allocation schemes was addressed by adopting the approach for the application of the materiality threshold for past due exposures that will give similar results regardless of the chosen approach to the allocation of payments. Therefore, it is not deemed necessary to regulate this aspect in the Guidelines.</p>	No change



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<p><b>Materiality threshold</b></p>	<p>Many respondents submitted comments relating to the materiality threshold for past due exposures. The issues that were mentioned included in particular the following:</p> <ul style="list-style-type: none"> <li>a. a suggestion that the compensation of past due amounts with unused general credit lines of the same debtor should be allowed;</li> <li>b. concerns regarding the potential lack of a relative component of the materiality threshold for retail exposures;</li> <li>c. proposals to increase the levels of the materiality threshold;</li> <li>d. concerns regarding factoring operations in the case of applying the threshold as proposed in the QIS exercise;</li> <li>e. a proposal to allow the computation of materiality threshold for 90 days past due at individual institution level as a first step (in the case of breach, dissemination and group-wide assessment would follow);</li> <li>f. a request to include examples on the calculation of the materiality threshold in the Guidelines.</li> </ul>	<p>The issues relating to the materiality threshold were addressed in the RTS on materiality threshold for past due exposures rather than in the Guidelines. The following considerations were taken into account when developing the final RTS:</p> <ul style="list-style-type: none"> <li>a. Compensation with unused credit lines should not be allowed, in order not to water down the effect of the materiality threshold.</li> <li>b. Both absolute and relative threshold components are considered for both retail and non-retail clients.</li> <li>c. Maximum levels of the thresholds were calibrated based on the results of the QIS and taking into account the industry’s feedback provided in the consultation process.</li> <li>d. The concerns related to factoring were addressed in the Guidelines by modifying the specification of a technical past due situation in paragraph 23(b).</li> <li>e. Application of the definition of default at the obligor level, including institution, parent undertaking and any of its subsidiaries, is a CRR requirement. Possible situations where a simplified approach may be applied are already described in paragraphs 81 and 82 of the Guidelines.</li> <li>f. As the materiality threshold is regulated by the RTS rather than the Guidelines it is not considered appropriate to include such examples in the Guidelines.</li> </ul>	<p>Par. 23(d)</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<b>Non-accrued status</b>	It was mentioned by some respondents that the accounting rules for non-accrued status are not specific enough, that it is not an IFRS concept, and even that the requirements in that regard should be deleted from the Guidelines or limited to entities where this information is available based on local GAAPs.	This indication of unlikelihood to pay is specified in Article 178(3)(a) of the CRR and hence cannot be overruled by the Guidelines. However, where non-accrued status is not applicable because of the specific accounting framework that is used this indication will not occur.	No change
<b>Bankruptcy</b>	One respondent suggested that the bankruptcy definition should refer to the list annexed to the Insolvency Regulation (EU) 2015/848, and to similar processes for financial institutions under e.g. the BRRD.  It was also suggested that the Guidelines should consider that bankruptcy orders often allow the debtor to retain primary residence and exclude mortgage payments from the action (such mortgage exposures should not be considered defaulted automatically).	It was clarified in paragraph 57 of the Guidelines that all arrangements listed in Annex A to Regulation (EU) 2015/848 should be treated as bankruptcy in the sense of Article 178 of the CRR.  Default in general is a characteristic of an obligor rather than an exposure. Hence, although bankruptcy procedures may exclude some types of exposures default of the obligor should be recognised. Recognition of default does not necessarily lead to immediately starting liquidation procedures.	Par. 57
<b>Unlikelihood to pay</b>	A few respondents regarded the criterion of unlikelihood to pay ‘significant (expected) increase of leverage’ as counterintuitive if the counterparty has improved its credit quality.  In the opinion of other respondents the relevant unlikelihood to pay triggers according to paragraph 47 should exclude circumstances related to the obligor’s financial distress or high vulnerability and should be limited to default/financial covenants.	Paragraphs 59 and 60 provide examples of possible additional indications of unlikelihood to pay. Institutions may decide not to adopt them or to adopt them in a modified version when deemed appropriate. In accordance with paragraph 58 the additional indications of unlikelihood to pay may be adopted on a case-by-case basis.  Regarding the covenants, also other than financial covenants could in some situations indicate financial problems on the part of an obligor. This should be analysed by the institutions depending on which types	No change



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
		of covenants are used in specific types of contracts.	
<b>Non-credit risk triggers</b>	<p>Several respondents made the general comment that the credit quality-related triggers should be the key drivers behind default recognition, otherwise issues may arise related to data instability as well as with regard to use test requirements if the non-credit-related regulatory default treatment is not reflected in credit decisions.</p> <p>A few respondents mentioned specifically credit frauds, which are perceived as operational rather than credit risk.</p>	<p>It is clear that the definition of default should be driven by credit quality-related triggers. However, where other triggers, such as credit frauds, lead to material delays in payment or unlikelihood to pay, this should also be recognised as default in accordance with Article 178 of the CRR. Otherwise capital requirements could be underestimated.</p>	No change
<b>External data</b>	<p>It was requested by one of the respondents that it should be clarified that the assessment of differences between definition of default used internally and in external data and their impact on the default rate should not be construed as an indication that the definition of default used in the external data has to be equivalent.</p>	<p>It is required by Article 178(4) of the CRR that if external data reflect different definitions of default appropriate adjustments should be made to achieve broad equivalence. All differences between the internal and external definitions should be analysed and, where possible, adjusted. In any case, where the default definitions in internal and external data are not fully equivalent the data should be considered less satisfactory and this should be reflected in an appropriate margin of conservatism in accordance with Article 179(1)(f) of the CRR.</p>	No change
<b>Promotional loans</b>	<p>It was requested by a few respondents that the specificities of promotional loans provided by development banks should be taken into account by adding them to the list of exceptions in paragraph 28 of the Consultation Paper and in the provisions on probation periods.</p>	<p>It was considered appropriate that the general principles specified in the Guidelines, unless stated otherwise, should apply to all types of loans, including promotional loans provided by development banks.</p>	No change



## Comments

## Summary of responses received

## EBA analysis

## Amendments to the proposals

### Responses to questions in Consultation Paper EBA/CP/2015/15

**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.**

#### Expert judgement

Many respondents requested that some flexibility should be maintained in the identification of technical defaults and that institutions should be allowed to use expert judgement in that regard. It was argued that otherwise the definition of default might not be in line with the use test and it would be less risk-sensitive for specific cases. For some respondents a strict definition of technical defaults would mean a major change from the current practice for non-retail activities, where no definition is given and where expert judgement is used to determine whether a past due status relates to a technical default or not. Such a strict definition could affect some customers that are not in financial difficulties but because of an inadequate definition of default may struggle to secure refinancing.

It was argued that the role of expert judgement could be limited and constrained by internal policies that are agreed upon with supervisors and supported by appropriate disclosures. It was also suggested that minimum guidelines could be established with examples of exceptions that take into account a common-sense approach and the ability to use expert judgement to determine non-credit-related events as is the case for the guidelines on sale of credit obligations.

A few respondents admitted that the proposed approach

In order to ensure consistent and comparable recognition of default across EU institutions it is considered important to avoid excessive subjectivity in the recognition of technical defaults.

In accordance with Article 178 of the CRR any situation that leads to material delay in payment or unlikelihood to pay should be considered default. In many cases it is difficult to clearly specify the reasons for the delay in payment, as they may be a combination of financial situation and external circumstances. Therefore, all cases of material delay in payment or where the institution considers it unlikely that the obligor will pay its credit obligations in full, regardless of the reasons, should be classified as defaults.

As so-called 'technical defaults' are not real defaults, i.e. in reality there is no material delay in payment or unlikelihood to pay, it is proposed in the final Guidelines that it is more appropriate to call certain events 'technical past due situation'. It follows that these situations should not be considered to lead to the recognition of default.

Those suggestions of the respondents that were in line with the above considerations were included in paragraph 23 of the final Guidelines.

Par. 23



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>may be acceptable for application to the retail business, where a more mechanical approach is more appropriate.</p>		
<p><b>Disputes</b></p>	<p>Many respondents argued that in the case of disputes over credit obligations the past due exposures should not be treated as defaulted. Such disputes are often resolved over long periods (even several years), which would mean that the borrower would remain in default throughout this period.</p> <p>Many respondents gave the example of commercial litigation with a client in the case of the leasing business where the quality of the product/service rendered is disputed, the service is no longer provided, or there is an equipment failure. In practice, litigation is generally avoided as the goal is to achieve an amicable solution with the lessee as customer. But finding a solution which is acceptable to both the lessee and the leasing company is often protracted.</p> <p>A similar situation can occur in factoring businesses where in a commercial relation between the factor's client (assignor) and its debtor there could be a dispute over a supply due to which the debtor decides not to pay the invoices. In this case, the disputed invoices or receivables should be excluded from the calculation of the default because the delay of the payment is not due to deterioration of the debtor's creditworthiness but to commercial/legal reasons.</p> <p>Other examples of disputes given by the respondents include commercial disputes over a standby letter of credit, call of suretyship where the suretyship contests</p>	<p>Although disputes are not included in the definition of a technical past due situation the argumentation of the respondents was taken into account and specific treatment of disputes has been specified in paragraph 19 of the Guidelines. However, in order to ensure consistent application of the definition of default and to avoid excessively broad application of the specific treatment, the possibility of suspending the counting of days past due was limited to those disputes that were introduced to a court or another formal procedure performed by a dedicated external body that results in a binding ruling (such as arbitration).</p> <p>In addition to that, the specific situation of leasing where the dispute may arise between the obligor and the provider of the leasing object rather than directly with the institution was addressed in point (b) of paragraph 19.</p> <p>With regard to purchased receivables, including those resulting from factoring arrangements, similar situations, i.e. disputes between the obligor and the supplier of goods, are addressed through the recognition of dilution risk as specified in the CRR and in paragraphs 29 and 30 of the Guidelines, that is, distinct from default risk.</p>	<p>Par. 19</p> <p>Par. 29-30</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>the legitimacy of the call, which entails a past due situation, and disputes regarding the amount or the nature of collaterals in the case of margin calls.</p>		
<p><b>Public sector</b></p>	<p>Several respondents indicated that in the case of public sector entities the delay in payment often results from the lengthy administrative procedures rather than from financial difficulties. A few respondents suggested that for sovereign counterparties default may be assessed at the political level. In addition to that an example was given of a merger of government entities where existing loans need to be transferred to the merged entity and technical delays in payment may occur due to that reason.</p> <p>The treatment of public sector entities was also mentioned in the context of factoring. Some respondents suggested inserting a specific provision that a default on trade debts of PSE debtors can be detected only when a crisis procedure has been activated on the single public entity or, at least, one of the following reliefs: (i) the introduction of a waiver that would allow the institution to suspend the counting of past due days if the debtor (being a public administration) makes a payment on at least one of its past due exposures, or (ii) to allow starting the counting of the days past due for receivables to public entities from the date when the payment is actually expected, according to the factor's experience or to reliable information pooled among institutions where available, rather than from the due date of the invoice. One respondent requested clarification of whether an intention to pay would be sufficient to reset the number</p>	<p>The systematic delays in payments by certain types of obligors are not desirable and wherever possible these obligors should be encouraged by the institutions to pay their obligations in a timely manner. In case of the necessity to carry out certain administrative procedures before extending the payment this should be envisaged in the payment schedule so that the delays can be avoided.</p> <p>However, in order to avoid unintended consequences for the financial and public sector in general the concerns of the respondents were addressed by specifying a specific treatment of exposures to central governments, local authorities and public sector entities in paragraphs 25 and 26 of the Guidelines. It has to be underlined that this specific treatment can only be applied where there is no concern regarding unlikelihood to pay. The specified criteria should be applied in a rigorous manner and the application of the specific treatment should be clearly documented to allow subsequent monitoring and analysis of these cases.</p> <p>It is clear that for the purpose of calculation of days past due only factually provided payments can be taken into account and the intention of payment is not sufficient in that regard.</p>	<p>Par. 25-26</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<b>Errors</b>	<p>of days past due for these obligors.</p> <p>It was suggested by several respondents that errors should be treated as technical defaults not only when they happen within the institution but also when they occur on the customer side. Complex customer groups are given as an example where multiple accounts and facilities may lead to potential system and administrative errors. Moreover, it was also requested that the closure or disruption of a payment system should be treated as a technical situation.</p> <p>One respondent indicated that recognition of a situation where the counterparty may be unable to make the payment at the time required for reasons other than financial difficulties would be consistent with industry documentation such as ISDA Master Agreements dealing with administrative/operational errors.</p>	<p>Delays in payments resulting from errors in the data or IT systems of the counterparty should not be considered technical past due situations, as it is the obligation of the debtor to provide the payment to the institution in a timely manner. It would be difficult for an institution to verify whether an error has actually occurred at the counterparty and such a possibility, if granted, could be misused. The obligors should not be encouraged to pay their obligations only on the last day before the recognition of default; rather, they should provide the payments in accordance with contractual obligations.</p> <p>However, it has been clarified that the failure of the payment system between the bank and the counterparty could be considered a source of technical defaults alongside errors on the part of banks; however, in that situation the obligor has to provide evidence that it attempted to make a payment but that it was unsuccessful due to the failure of the payment system.</p>	Par. 23(b)
<b>Allocation of payments</b>	<p>It was indicated by a few respondents that, in factoring, payments might be made by debtors to a factor for certain ceded invoices and not yet registered on the right account due to difficulties in the payment reconciliation process. This should not lead to recognition of default. Other respondents mentioned that invoices may be due but not correctly and promptly dispatched to the debtor</p>	<p>It has already been specified in the Consultation Paper that in the case of a time lag between the receipt of a payment by an institution and the allocation of that payment to the relevant account this transitional period may be considered a technical past due situation, and this provision remains in the final Guidelines in paragraph 23(c).</p>	Par. 31-32



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	by the seller.	The treatment of payments to the seller instead of the institution and the treatment of payments in the case of undisclosed factoring have been further specified in paragraphs 31 and 32.	
<b>External events</b>	Several respondents indicated that some external events could lead to technical defaults. The examples of such events include environmental disasters, measures imposed by law (e.g. obligations due to capital controls imposed on the Greek banking system last year), riots, strikes, wars, etc. In the case of trade finance or the funding of energy and commodities, these external events could be related to logistical issues and reasons that lead to delivery delays, such as the goods being blocked at customs, prohibitions on entering or leaving ports, strikes, etc. Other respondents noted that some positions may be reported as expired due to bureaucratic delays of various types (for example, time needed to formalise resolutions, availability of notaries, time required for the registration of mortgages). In more general terms such situations were mentioned where past due amounts are attributable to operational risk, or 'blended events' (i.e. where there are several risk types at play) and where a decision needs to be taken as to whether it is appropriate or not to take such an event into account for credit risk requirement purposes.	External events that are not related to the obligor, such as environmental disasters, measures imposed by law, riots, strikes, wars or logistical issues, should not be considered technical defaults (or technical past due situations as specified in the Guidelines). All individuals and entities operate in an environment of uncertainty where they are affected by external events. This uncertainty is a part of the risk that has to be taken into account by the institutions when estimating credit risk and calculating capital requirements. Capital requirements should in particular be sufficient to absorb losses stemming from external events that affect both clients and institutions. Therefore, these situations, including events related to country risk, cannot be treated as technical past due situations and have to be included in the estimation of risk parameters.	No change
<b>Factoring</b>	A few situations were indicated by the respondents in the context of factoring that could lead to technical defaults. These situations include:  a. extension of payment terms granted to the debtor but	The following considerations were taken into account in relation to the comments submitted by the respondents:  a. As a general rule the calculation of days past due	Par. 31-32



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>not yet registered on the factor's system;</p> <p>b. discounts, deductions, netting or other credit invoices issued by the seller but not promptly communicated to the factor or not directly linked to the invoices;</p> <p>c. wrong payments by the debtor to the supplier;</p> <p>d. delay in the transfer of information about the collected receivables by the seller in non-notification factoring agreements or when the client acts as agent for the collection;</p> <p>e. delay in the registration of the collected amounts in non-notification factoring agreements or when the client acts as agent for the collection;</p> <p>f. payments by the buyer without indication of the paid invoices.</p>	<p>should always be based on the most up-to-date schedule of payments.</p> <p>b. These events are related to dilution risk and should be recognised when calculating capital requirements for dilution risk.</p> <p>c-e. The treatment of payments to the seller instead of the institution and the treatment of payments in the case of undisclosed factoring have been specified in paragraphs 31 and 32.</p> <p>f. This situation will most probably result in a time lag between the receipt of the payment and its allocation to the relevant account, which is already addressed in paragraph 23(c) of the Guidelines.</p>	
<b>Leasing</b>	<p>In the case of leasing it was mentioned that procedural aspects are quite frequently to be found in vehicle leasing to corporate lessees with a large number of leases (fleet leasing), especially if the lease payments are due on different dates. There is typically a lag between invoicing and settlement of the invoice. Default may be triggered even if none of the open invoices is past due more than 90 days.</p>	<p>It is the obligation of the institution to issue the invoices in a timely manner to allow the obligor to make the payments in accordance with the payment schedule. Where there is a time lag between the receipt and the allocation of the payment this situation is addressed by paragraph 23(c).</p>	No change
<b>Syndicated financing</b>	<p>One respondent mentioned an example where there is a delay in passing payments between the syndicate members involved or if the institution restructures the loans without default (crisis-related restructuring). This can arise, for example, if the internal limit has already</p>	<p>In the case of changes in the terms and conditions of a loan, including in particular increase of the limit, where this is due to financial difficulties of the obligor, such changes should be considered distressed restructuring and should be treated accordingly in the</p>	No change



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	been increased, but the agreement in the lender consortium cannot be achieved within 90 days.	recognition of default. The definition and treatment of distressed restructuring has been specified in paragraphs 49 to 55 of the Guidelines.	
<b>Long-term loans</b>	With regard to asset financing long-term loans it was mentioned that amendments, waivers or consents are possible due to, for example, a lack of customer responsiveness, a maintenance check of products or a reality check of the financing according to new market conditions. It was deemed necessary to use expert assessment in such cases.	Wherever changes of terms and conditions result from financial difficulties of the obligor this should be considered distressed restructuring and treated accordingly in the recognition of default. In any case institutions should perform an analysis of the potential unlikelihood to pay of the obligor and classify an obligor as defaulted where concerns in that regard exist.	No change
<b>Mergers and acquisitions</b>	A few respondents requested clarification that should a defaulted client of a bank be bought by another client of the bank (client B) that is not in default, the exposures of client B should not be considered defaulted if there is no decrease in the credit quality of client B (due to the acquisition).	In accordance with the comments received it has been clarified in paragraph 20 of the Guidelines that if the obligor changes then the counting of days past due starts for the new obligor from the beginning. If, however, the obligor (legal entity) does not change then there is no reason to apply a different treatment and in particular there is no merit in considering such cases technical past due situations.	Par. 20
<b>No additions to technical defaults</b>	A few respondents agreed with the proposal and did not see a need for additional types of technical defaults.	The list of technical past due situations is strictly limited to those situations where no material delay in payments and no concern about unlikelihood to pay exist.	No change
<b>Application of technical defaults</b>	A few respondents requested additional clarification on the application of the definition of technical defaults: in particular they asked for clarification that the technical defaults that do not lead to actual default do not need to	The technical past due situation should not be considered default and therefore the criteria for a return to non-defaulted status do not apply. Any identified errors should be corrected as soon as	No change



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>be registered in a central risk database, and registration in the local database for audit trails would suffice. Moreover, it should be clarified that in the case of technical defaults it is possible to automatically restore positions to non-defaulted status without having to trigger an individual restoration process including individual documentation. This option should be applicable for restructuring and all other retail exposures.</p>	<p>possible. It has also been clarified in paragraph 24 of the Guidelines that technical past due situations, where identified, should be removed from the reference data set of defaulted exposures for the purpose of estimation of risk parameters.</p>	
<p><b>Relation to LGD</b></p>	<p>It was requested by a few respondents that if the EBA’s definition of default (defined, among other ways, by new and stricter rules on technical default) remains unchanged, floors on the minimum level of LGD have to be reduced or completely removed.</p>	<p>The aspect of LGD floors is not covered by the scope of these Guidelines.</p>	<p>No change</p>
<p><b>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?</b></p>			
<p><b>Requests for clarification</b></p>	<p>Several respondents requested clarification with regard to factoring with and without full transfer of risks and benefits, especially in situations where local accounting standards are used. Also, clarification was requested in general terms of what is the relation between the paragraphs in the Guidelines that refer to factoring and other parts of the Guidelines, in particular in Chapter 4 of the Guidelines. Furthermore, some respondents wondered whether the same requirements as for factoring would apply also to other economically similar financial products regardless of the terminology.</p>	<p>It was clarified in paragraphs 27 and 28 of the Guidelines that the differentiation between the types of factoring arrangements is based on whether the receivables are actually purchased by the institutions and recognised in the institution’s balance sheet or not. As in accordance with the CRR the risk weights are applied to all assets on the institution’s balance sheet, the same rule applies independently from the applicable accounting standards.</p> <p>Furthermore, it has to be noted that where the scope of application is not specifically mentioned all other</p>	<p>Par. 27-32</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
		<p>parts of the Guidelines apply equally to all types of exposures including those that result from factoring arrangements. However, paragraphs 27 to 32 of the Guidelines define specific rules that apply specifically to factoring and/or purchased receivables, where purchased receivables may stem from factoring arrangements or another type of transaction.</p>	
	<p>Clarification was requested of whether the approach proposed for factoring is valid for institutions adopting the Standardised Approach and those adopting the IRB Approach, taking into account in particular the derogations for purchased receivables as allowed by the CRR under the IRB Approach.</p>	<p>Unless it is specifically mentioned the Guidelines apply equally to institutions that use the IRB and the Standardised Approach.</p>	<p>No change</p>
	<p>Some respondents asked for clarification of the treatment of situations where the debtor has not been informed about the cession and the debtor continues making the payments to the seller instead of the factor. Some suggest that this situation should be considered a technical default.</p>	<p>Clarification on the treatment of payments made directly to the seller has been provided in paragraphs 31 and 32 of the Guidelines. Differentiation has been introduced depending on whether the debtor has been adequately informed about the cession. In any case, however, this situation should not be treated as technical default (technical past due situation).</p>	<p>Par. 31-32</p>
	<p>One respondent asked for clarification of whether factoring without full transfer of risks and benefits should be treated similarly to an overdraft (i.e. taking into account the advised limit) or whether the agreed percentage of advances should be taken into account.</p>	<p>The treatment of factoring that does not lead to the recognition of purchased receivables in the balance sheet of the institution has been specified in paragraph 27. Although there are some similarities to overdrafts, as explained in the section on background and rationale, the treatment specified in paragraph 27 is specific to this type of factoring.</p>	<p>No change</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<b>Expert judgement</b>	<p>Several respondents disagreed with automatic recognition of default in the case of factoring. Some suggested determination of default on a case-by-case basis if factoring arrangements have sufficient material impact to cause the obligor to default on its other obligations. It was mentioned in particular that judgemental assessment should be allowed if the same counterparty is both a client and a debtor to another client.</p>	<p>The backstop, i.e. the latest possible moment for the recognition of default, has to be specified in an objective manner in order to ensure sufficient comparability across institutions. In the CRR such a backstop has been defined in Article 178(1)(b) as a days past due criterion. However, until that moment institutions may recognise default on the basis of unlikelihood to pay considerations, which leaves room for judgemental assessment of the financial situation of the obligor.</p>	No change
<b>Dilution risk</b>	<p>In the case of factoring with full transfer of risks and benefits many respondents suggested that the calculation of the threshold should not take into account events which are strictly related to the commercial relationship between the debtor and the client (e.g. disputes, discounts, deductions, netting, credit note issued by the seller). The suggestions on how to address these events include a rebuttable presumption on the automatic classification of days past due, suspension of days past due counting and exclusion of the relevant invoices in the calculation of the threshold. However, the respondents admit that these occurrences should trigger an analysis of the debtor's situation in order to assess possible indications of unlikelihood to pay.</p>	<p>Dilution risk, as specified in the CRR, applies to portfolios of purchased receivables regardless of whether they stem from factoring arrangements or any other transactions. The treatment of events related to dilution risk has been further clarified in paragraphs 29 and 30 of the Guidelines. It is also stressed that a significant number of events related to dilution risk may indicate potential unlikelihood to pay and in this situation an appropriate assessment has to be performed.</p>	Par. 29-30
<b>Reference date for DPD</b>	<p>One respondent suggested that, in the case of factoring with full transfer of risks and benefits, in order to classify a single receivable as past due, the reference date should not be the maturity date of the receivable but the maturity date contracted with the assignor or the DSO</p>	<p>In accordance with general principles the calculation of days past due should always refer to the dates of contractual obligations. In the case of a purchased receivable the date of contractual obligation is the due date of the receivable. However, the specific case of</p>	Par. 32



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>(days of sales outstanding) plus any increase, which is the date used for determining the sale price of the assigned receivables.</p>	<p>undisclosed factoring has been clarified in paragraph 32 of the Guidelines. In this case, as the debtors do not have an obligation to pay directly to the institution, the contractual obligations of the seller are taken into account for the purpose of counting of days past due.</p>	
	<p>In the case of factoring without full transfer of risks and benefits a few respondents requested adding a provision that when the factor and the client agree a due date for the credit granted to the client, the counting of past due days shall commence from such date, regardless of the account that is in debt.</p>	<p>The general requirement that the counting of days past due should always refer to the most up-to-date contractual obligations applies also to factoring arrangements. However, it also has to be noted that where the contractual obligations are changed due to financial difficulties of the obligor this should be considered a distressed restructuring and in this case relevant provisions of the Guidelines on the treatment of distressed restructuring will also apply.</p>	<p>No change</p>
<p><b>Question 3. Do you agree with the approach proposed for the treatment of specific credit risk adjustments (SCRA)?</b></p>			
	<p>Most of the respondents agreed with the proposed rules for the treatment of specific credit risk adjustments (SCRA) and appreciated the alignment of these rules with the accounting standards. However, some respondents requested additional clarification on the treatment of exposures classified as Stage 2 under IFRS 9 to make sure that these exposures do not have to be treated as defaulted. It was considered that a decrease in book value, even due to a decrease in credit quality, should not necessarily be judged as default, especially in the case of exposures measured at fair value.</p>	<p>It has been specified that only exposures that are classified as credit-impaired under IFRS 9 have to be treated as defaulted, with certain exceptions as specified in paragraph 39 of the Guidelines. Exposures classified as Stage 2 under IFRS 9 are not credit-impaired and therefore they are in general not treated as defaulted. However, these exposures may be classified as defaulted if they are materially past due or any other indications of unlikelihood to pay exist.</p>	<p>Par. 39</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>Several respondents indicated that some assets classified as Stage 3 should not be treated as defaulted. The examples included in particular assets purchased or originated at a significant credit-related discount and hence classified as credit-impaired. Some respondents were concerned that assets that are credit-impaired at origination would have to remain defaulted until maturity.</p>	<p>The treatment of assets purchased or originated at a significant credit-related discount has been specified in paragraph 62 of the Guidelines. Such assets should be assessed for potential unlikelihood to pay, which is the basis for the decision regarding whether these assets should be treated as defaulted or not. As a result there is no automatism in classification of assets purchased or originated at a discount as defaulted. A similar assessment is performed for the purpose of classification of exposures as credit-impaired for accounting purposes. Once the exposures are classified as defaulted the general criteria for a return to non-defaulted status apply as specified in Chapter 7 of the Guidelines.</p>	<p>Par. 62</p>
	<p>Some respondents were concerned about the differences between the accounting rules and the provisions specified for a return to non-defaulted status.</p>	<p>The accounting standards specify how to construct a balance sheet for the institution that reflects a situation at a certain point in time, whereas the prudential requirements have to be met on an ongoing basis, and therefore the exact date of reclassification is necessary. Moreover, the definition of default used for prudential purposes may also be used for accounting purposes, including the criteria for reclassification.</p>	<p>No change</p>
	<p>A few respondents suggested that a threshold should be applied to the recognition of default based on specific credit risk adjustments.</p>	<p>According to Article 178(3)(b) of the CRR whenever the institution recognises a specific credit adjustment resulting from a significant perceived decline in credit quality subsequent to the institution taking on the exposure this should be considered an indication of unlikelihood to pay. Therefore, the Guidelines specify</p>	<p>No change</p>



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		which SCRA should be considered to result from a significant decline in the credit quality of the exposure and there is no need for specifying a threshold.	
	There was a formal remark from one respondent that the term 'Stage 3' should not be used, as it is not formally defined in IFRS 9.	The comment has been incorporated and the Guidelines refer to exposures that are 'credit-impaired'.	Par. 39
	One respondent indicated potential inconsistency between the RTS on the general and specific credit risk adjustments and the proposed rules. According to this respondent these RTS prescribe that for the purpose of Article 178 of the CRR only SCRA directly for individual exposures should be used and SCRA for a portfolio should be excluded even if it is mapped onto the individual exposures, whereas in the draft Guidelines it is proposed that collectively assessed SCRA is also an indication of unlikelihood to pay.	It has been specified in the Guidelines that SCRA based on losses resulting from current or past events should be considered an indication of unlikelihood to pay. Although the level of provisions may be assessed individually or collectively (in particular for exposures that are not individually significant) the classification of exposures as those where the event of loss has already occurred is done on an individual basis. Therefore, the SCRA is specified directly for individual exposures. In contrast to this, as specified in paragraph 37 of the Guidelines, where the loss has occurred but the institution is not yet aware of which individual exposure has suffered these losses this should not be considered an indication of unlikelihood to pay of a specific obligor.	No change
<b>Question 4. Do you consider the proposed treatment of the sale of credit obligations appropriate for the purpose of identification of default?</b>			
<b>Level of the threshold</b>	While a few respondents agreed with the proposed treatment of the sale of credit obligations many respondents suggested increasing the proposed threshold for the loss on the sale of credit obligations. One respondent indicated that the threshold should be	The price for a credit obligation reflects in general the expectation of the future cash flows on the exposure. Where the price is significantly lower than the outstanding amount this indicates unlikelihood to pay with regard to this obligation. Where, however, the	No change



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	<p>significantly increased to avoid situations where exposures with a PD that is material but significantly below 100% is classified as defaulted. This respondent also argued that as LGD and in particular the existing collateral affects the sale price the loss in general should not be the basis for the recognition of default.</p>	<p>discount results from other than credit-quality-related reasons this situation is addressed in paragraph 42 of the Guidelines.</p>	
<b>Application of the threshold</b>	<p>Several respondents requested that objective criteria to determine losses due to credit risk should be specified, as many factors other than credit-related can substantially influence the price and therefore these should be excluded.</p>	<p>The treatment of non-credit-risk-related factors that influence the price for credit obligations has been specified in paragraph 42 of the Guidelines. Where the economic loss related to the sale of credit obligations is considered not credit-related the sale should not be considered an indication of default.</p>	No change
	<p>A few respondents suggested that the exposure in the formula for the threshold should be discounted to reflect the timing of the payments.</p>	<p>Introduction of discounting in the formula would lead to excessive complexity. It was considered that the formula should be rather simple. It takes into account the outstanding amount at the moment of the sale and does not include any future interest. These future interests reflect the value of the payments in time for the investor and hence the price for well-performing obligations should cover at least the current outstanding amount (i.e. mostly the value of the principal).</p>	No change
	<p>Several respondents noted that the portfolio subject to the sale is often heterogeneous and may in particular include performing and non-performing exposures. Some respondents suggested that exposures should be grouped into homogeneous pools in terms of credit quality and that not all exposures should be defaulted as a result of</p>	<p>It is specified in paragraph 48 of the Guidelines that the treatment of individual credit obligations within this portfolio should be determined in accordance with how the price for the portfolio was set. Where the price for the portfolio is set only at the portfolio level it is assumed that the exposures included in this</p>	No change



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	the sale.	portfolio are sufficiently homogeneous and can be treated similarly in terms of the identification of default. Where, however, both performing and non-performing exposures are subject to the sale it is likely that the price will differ for different parts of the sold portfolio. In this case the threshold will apply separately to each part of the portfolio that was separately priced.	
<b>Requests for clarification</b>	Several respondents indicated that the default trigger based on the sale of credit obligations should be considered an auxiliary indicator as exposures are typically defaulted before sale.	The sale of credit obligations as a default trigger is relevant for exposures that are not yet defaulted at the moment of the sale. In the case exposures defaulted before their sale, such sale will not define the moment of default but will determine the level of loss related to the previously defaulted exposure. In the case of institutions that use the advanced IRB Approach this information should be adequately recorded and stored for the purpose of LGD estimation process.	No change
	Several respondents requested clarification of whether securitised exposures qualify as sold exposures.	It has been clarified in paragraph 41 that transactions of traditional securitisation should be considered sale of credit obligations where they lead to significant risk transfer.	Par. 41
	One respondent asked for clarification of the treatment of the exposures to a client that remain on the book when some of the exposures to this client have been sold by the institution, and in particular of whether the pulling effect could be applied in this case.	The treatment of partial sale of credit obligations of an obligor is described in paragraph 47 of the Guidelines. The pulling effect is not an obligatory indication of default but institutions may use it where it is considered appropriate. Therefore, in the case of retail exposures where default definition is applied at the	No change



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		<p>facility level, institutions should decide themselves whether they will use the pulling effect and, if so, whether it will include the value of sold credit obligations.</p>	
<b>Implementation</b>	<p>Some respondents expressed concerns about the application of the threshold retrospectively. They argued that the behaviour of sellers would have been different had the proposed rules been in force at the time of sale. In addition it was mentioned that reporting and documentation subsequent to a sale might be technically challenging if no exposures to the client exist any more.</p>	<p>Treatment of the sale of credit obligations at a material credit-related economic loss as an indication of default is already required by Article 178(3)(c) of the CRR and hence the obligation to store this information for the purpose of estimation of risk parameters under the IRB Approach existed before the application of these Guidelines. Where the historical information is considered not representative of the current conditions this should be treated appropriately in the estimation of risk parameters. More guidance in this regard will be provided in the EBA Guidelines on the estimation of risk parameters.</p>	No change
<b>Other comments</b>	<p>One respondent proposed determining default in case of the sale of credit obligations by assessing whether there would have been an individual impairment adjustment on the exposure without the sale transaction, instead of the application of the threshold.</p>	<p>In order to achieve greater comparability of capital requirements across institutions the rules regarding the recognition of default should be as far as possible objective and independent of the applicable accounting framework. The approach proposed by the respondent would lead to excessive subjectivity of the assessment and would also depend on the locally applicable expectations with regard to the impairment adjustments.</p>	No change
<p><b>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?</b></p>			



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<b>Level of the threshold</b>	<p>Many respondents suggested that the proposed threshold should be increased; some suggested up to 5% or even up to 10%. A few respondents were of the opinion that the threshold should be removed and that instead the relevant measure for recognition of default should be set at a level when the new cash flow (NPV) would no longer be adequate to cover the value at origination of the obligation, regardless of the decline in NPV.</p> <p>One respondent suggested that similar thresholds should be used for all comparisons (e.g. distressed restructuring, discount in case of sale of obligations).</p>	<p>Distressed restructuring should lead to recognition of default whenever it leads to diminished financial obligation caused by material forgiveness, or postponement, of principal, interest or, where relevant fees. As the term distressed restructuring already implies that an obligor is facing substantial financial difficulties, the main purpose of the specified threshold is to avoid the recognition of default due to some technicalities related to the calculation of NPV, rather than to reflect the materiality of the loss. The other thresholds apply to different values and have a different economic rationale; therefore, there is no justification for using the same level of threshold.</p>	No change
<b>Interest rate</b>	<p>The majority of respondents supported the use of the original effective interest rate while a few respondents were in favour of using the current (before signing the restructuring contract) effective interest rate.</p>	<p>The majority view of the respondents was taken into account and, as proposed in the Consultation Paper, the original effective interest rate was specified as the appropriate discounting factor for the purpose of NPV calculation.</p>	No change
	<p>Many respondents asked for clarification on the treatment of variable rate contracts (here it was suggested that the variable component should be used at the current level together with the spread that was negotiated originally in the contract). In addition it was suggested that a certain approximation should be allowed in line with IFRS. In addition some respondents asked for clarification of the rule for those institutions that do not use IFRS and suggested that these banks should be allowed to use a different interest rate for the purpose of discounting cash flows. Furthermore, clarification was</p>	<p>It has been specified that NPV should be calculated with the use of the original effective interest rate as a discounting factor in order to align the rule with accounting practices. Therefore, any approximation of such rate or treatment of variable rates that is used for accounting purposes should also be used in the calculation of NPV for the purpose of default identification.</p> <p>It has to be stressed that the calculation of diminished financial obligation is relevant only to distressed</p>	No change



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>requested of which interest rate should be used in the case of purchased or originated credit-impaired financial assets.</p> <p>Finally, it was argued by a respondent that the classification to defaulted status of the distressed restructuring should not be based on the ‘impairment test’ for accounting purposes, as the objective of this test is only to evaluate when an impairment has been produced as a consequence of modification of a contract and not to determine whether the exposure is defaulted.</p>	<p>restructuring, i.e. the restructuring that results from financial difficulties of the obligor. In this situation, whenever the financial obligation has diminished as a result of material forgiveness, or postponement, of principal, interest or, where relevant fees, default should be recognised.</p>	
<b>Application of the threshold</b>	<p>Several respondents asked for clarification of whether the formula for the loss calculation includes cash flows from recoveries.</p>	<p>The formula for NPV both before and after the restructuring arrangements is based only on the contractual schedules of payments and not on the cash flows that are actually expected, where they are different.</p>	No change
	<p>Some respondents requested further alignment with IFRS 9, according to which banks shall assess significant increase in credit risk but forbearance measures that diminish the cash flows of the contract do not necessarily automatically result in a credit-impaired status (defaulted status) under IFRS 9.</p>	<p>The Guidelines only provide further clarification on the application of Article 178 of the CRR and cannot contradict it. According to Article 178(3)(d) of the CRR distressed restructuring that is likely to result in a diminished financial obligation caused by material forgiveness, or postponement, of principal, interest or, where relevant fees should be considered an indication of unlikelihood to pay.</p>	No change
	<p>Some respondents indicated cases where the threshold might not work properly. These include a situation where the interest reset date has been passed in the case of defaulted exposures and the exposures are therefore subject to daily interest rates (as in these cases the</p>	<p>The Guidelines were specified with the intention of not introducing excessive complexity. The proposed approach to the assessment of diminished financial obligations should be sufficiently universal to be applied to any type of exposure. This calculation is</p>	No change



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	<p>proposed present value test would always lead to a default) and where a lower interest rate after a distressed restructuring might be due to lower risk if the restructuring brought in additional collateral or an increase in seniority.</p>	<p>only relevant to exposures that are not yet defaulted before the restructuring arrangements. In order to be able to compare the financial obligations, the NPV before and after restructuring should be calculated with the use of the same discounting factor. The potential additional collateral may contribute to a more effective recovery processes in the case of default but in general does not change the fact of whether default has occurred or not.</p>	
	<p>One respondent proposed that the calculation of loss that results from the comparison of the NPVs of the cash flows before and after restructuring should account for available collateral. Transactions with solid collaterals or relating to exposures past due where the customer has increased the level of collaterals or paid the underlying interest should not be classified as distressed restructuring.</p>	<p>The existence of collateral may contribute to a more effective recovery process in the case of default but it cannot be used to avoid the identification of default.</p>	<p>No change</p>
<p><b>Other comments</b></p>	<p>A few respondents argued that paragraph 43 of the draft Guidelines, which requires that all forborne non-performing exposures should be classified as defaulted and subject to distressed restructuring, should be deleted. This is seen as contradictory to the statement included in the accompanying documents that the alignment of the definition of default with the non-performing exposures should be non-obligatory.</p>	<p>The accompanying documents include the analysis of various options considered in the process of the specification of the Guidelines but the final policy choices are reflected in the legal text of the Guidelines. While it was proposed that the pulling effect used for the purpose of supervisory reporting should not be treated as an obligatory indication of unlikelihood to pay in the identification of default, it was considered important to specify that all forborne non-performing exposures should be classified as defaulted.</p>	<p>No change</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>Several respondents indicated that it should be made clear that the concept of distressed restructuring should not apply if a revision of the conditions is allowed by the contract or by specific laws or where the conditions are changed based on commercial renegotiations.</p>	<p>The definition of distressed restructuring has been aligned with the definition of forbearance used for the purpose of supervisory reporting. As forbearance refers only to such changes of terms and conditions resulting from financial difficulties of the obligor, only such situations should be treated as potential indications of unlikelihood to pay in accordance with Article 178(3)(d) of the CRR.</p>	<p>No change</p>
	<p>A concern was expressed by some respondents that the proposed rules may lead to an increase in non-performing loans, as currently in the case of the first forbearance measure 'under probation' a default only occurs after the 30 days past due criterion or after the implementation of the second forbearance measure. These respondents suggested that the current methodology should be maintained.</p>	<p>The Guidelines do not change the rules for supervisory reporting. Rather, some of the rules that apply in supervisory reporting were transposed into default identification processes in order to achieve greater alignment. In particular it has been specified that all forborne non-performing exposures should be classified as defaulted. This rule will not increase the number of non-performing loans but, depending on the currently applicable practices, may lead to the recognition of more defaults.</p> <p>However, where the currently applied practices in the recognition of default are less strict than those specified in the Guidelines and the exposures defaulted in accordance with the Guidelines were not previously classified as non-performing, an increase in non-performing loans may result from the rule that all defaulted exposures should be reported as non-performing.</p>	<p>No change</p>
	<p>One respondent saw the proposal for calculation of NPV as overly burdensome.</p>	<p>As the calculation of NPV should be applied for the purpose of the identification of default, it only applies</p>	<p>No change</p>



## Comments

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to those exposures that are subject to distressed restructuring and have not been recognised as defaulted yet. As the calculation is based only on actual contractual obligations with an interest rate that is already used for accounting purposes, it should not be overly burdensome.

### Q6. Do you agree that the purchase or origination of a financial asset at a material discount should be treated as an indication of unlikelihood to pay?

The majority of respondents were of the opinion that the purchase or origination of a financial asset at a material discount should not be treated as an indication of unlikelihood to pay or that it should only be treated as such if this material discount is due to credit quality issues. It was argued that, otherwise, performing clients would need to be classified as in default. However, some respondents supported this event being an indication of unlikelihood to pay or suggested that it should be an auxiliary indicator.

Some respondents suggested that the treatment of the purchase or origination of a financial asset at a material discount should be aligned with the treatment of the sale of credit obligations. It was, however, also noted that the treatment would not be appropriate for the purchase of a portfolio where the discount should not necessarily lead to default on all assets but maybe just some of them. Hence the treatment should entail individual assessment of the creditworthiness of the obligor and should not rely solely on rating agency downgrades.

The treatment of the purchase or origination of a financial asset at a material discount has been specified in paragraph 62 of the Guidelines. This approach will ensure greater comparability across institutions and will provide alignment with the accounting standards. It has been specified that the asset should be considered defaulted only in the case of unlikelihood to pay considerations. A similar assessment is performed for accounting purposes in order to decide whether the asset should be considered impaired. This approach will ensure that the classification of exposures as defaulted will be based on the assessment of the credit quality of the exposures.

Although there is a clear relation between the purchase and the sale of a portfolio, especially in the case of intragroup transactions, where the assessment of the credit quality of the obligors should be consistent, full alignment of the treatment was not considered appropriate. In the case of the sale of credit obligations the price received by the institution determines the final economic loss related to this

Par. 62



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		<p>exposure. In the case of the purchase of an asset the price does not indicate the final outcome but is rather a starting point for the assessment.</p>	
	<p>Some respondents requested clarification on the criteria for a return to non-defaulted status in the case of exposures defaulted at the moment of purchase or origination.</p>	<p>As the classification to defaulted status will be based on the assessment of the unlikeliness to pay of the credit obligation, the same criteria for a return to non-defaulted status will apply as in the case of any other indication of unlikeliness to pay.</p>	<p>No change</p>
<p><b>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?</b></p>			
<p><b>Fixed minimum probation periods</b></p>	<p>The majority of respondents did not agree with fixed probation periods, and the arguments include, among others, possible inconsistency with Article 178(5) of the CRR, lack of alignment with IFRS 9 and consequences for internal management practices. The respondents in general prefer more flexibility in setting probation periods and in some situations it should be possible to shorten the probation period. It is also argued that institutions should be able to choose those tried and trusted periods from their individual internal risk management.</p> <p>A few respondents suggested that the probation period should not apply if default is triggered on the basis of the days past due criterion.</p> <p>However, several respondents agreed with the proposal for the probation period and expressed support for rationalising and aligning the conditions for reclassification to a non-defaulted status.</p>	<p>The specification of the probation period is based on the assumption that where default has been recognised the assessment of unlikeliness to pay should be more cautious. The application of the probation period should prevent frequent reclassifications of exposures where unlikeliness to pay may still exist.</p> <p>The same consideration applies to those cases where default is triggered on the basis of the days past due criterion, as, before reclassification, institutions should make sure that the improvement of the financial situation of the obligor is permanent and that the reclassification is not a result of a one-off payment.</p> <p>It also has to be stressed that the Guidelines specify only minimum lengths for probation periods and, where appropriate, institutions may apply longer periods. In particular, the length of the probation</p>	<p>No change</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
		<p>period may be different for different types of exposures.</p>	
<p><b>Length of the probation period</b></p>	<p>Several respondents argued that the 3-month probation period is too long for both large corporate exposures and retail consumers, in particular when applied together with the strict definition of technical default. Other respondents suggested that the length should be different for different types of products, customers or triggers of default. However, some respondents envisaged that applying changed probation periods to historical defaults would be challenging in the recalibration of IRB models, especially if different probation periods are applied to different types of default events. One respondent proposed that in order to address short-term instruments the probation period could be set in terms of a percentage of the remaining period.</p>	<p>It is considered that the 3-month probation period is the shortest period during which a meaningful assessment of the improvement of the credit quality of the exposures can be performed. This is also consistent with the results of the QIS, which indicate that where probation periods are used they have a length of at least 3 months and in many cases much longer probation periods are used.</p> <p>Regarding the differentiation of the length of such periods it was decided that institutions should be allowed to decide whether such differentiation is appropriate in a specific situation. Therefore, institutions may apply different probation periods for different types of exposures but each of those probation periods has to be at least 3 months.</p>	<p>No change</p>
<p><b>Alignment</b></p>	<p>Many respondents mentioned the importance of aligning regulatory proposals with the treatment of non-performing loans in supervisory reporting and with IFRS 9. In particular, concerns were expressed in the context of exposures classified as Stage 2 under IFRS 9.</p>	<p>The application of probation periods does not affect the alignment with supervisory reporting. As all defaulted exposures have to be reported as non-performing the exposures will remain non-performing until the end of the probation period and until the reclassification to non-defaulted status or the termination of the exposure. As a result the classification of exposures as non-performing will remain consistent with their classification as defaulted.</p>	<p>No change</p>
		<p>With regard to IFRS 9 it is in general recommended</p>	



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
		<p>that for accounting purposes the same definition of default should be used as for prudential purposes. This includes in particular the criteria for the reclassification of exposures. It has to be noted that in the case of IFRS 9 this alignment will refer to exposures classified as Stage 3, whereas exposures in Stage 2 are not considered defaulted unless other indications of unlikelihood to pay are observed.</p>	
<b>Alternative solution</b>	<p>One respondent presented an alternative proposal that instead of probation periods a maximum relative amount of multiple defaults could be introduced.</p>	<p>This proposal could potentially achieve similar objectives to those of the probation periods but it was not included in the Guidelines as it is not in line with the current practices of the institutions and it could be difficult to implement for institutions that use the Standardised Approach.</p>	No change
<b>Material payment</b>	<p>A few respondents suggested that in the case of distressed restructuring the requirement should be aligned with the reporting framework and the obligor should either make a material payment or otherwise demonstrate the ability to comply with the post-forbearance conditions.</p>	<p>As all defaulted exposures have to be reported as non-performing the alignment with the reporting framework has not been compromised. Institutions should be particularly cautious when reclassifying exposures that were subject to distressed restructuring and it is important that material payment be made before reclassification. Only this way can the obligor truly demonstrate both the ability and the willingness to repay the obligation in accordance with the post-restructuring conditions.</p>	No change
<b>Grace period</b>	<p>Several respondents requested clarification of which repayment suspensions shall be considered a 'grace period' in accordance with paragraph 59 of the Consultation Paper. The postponement of a due</p>	<p>A 'grace period' as referred to in paragraph 72 of the Guidelines should be understood as a period during which no or only interest payments are required. However, institutions should also assess unlikelihood</p>	Par. 53



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	instalment and/or due interest and/or a due fee towards the end of the credit period should not be considered an extension of the 'grace period' towards the end of the credit period. Should such postponement be considered a 'grace period' this would indicate that the 1-year minimum period starts at the end of the credit period.	to pay in the context of the specific repayment schedule. In accordance with paragraph 52 of the Guidelines an irregular repayment schedule where significantly lower payments are envisaged at the beginning of the repayment schedule, a large lump sum payment is envisaged at the end of the repayment schedule or a significant grace period is envisaged at the beginning of the repayment schedule may indicate unlikelihood to pay.	
<b>Partial losses</b>	Clarification was requested of how to treat exposures with incurred partial losses.	No additional conditions were added in the Guidelines as it is considered that it is possible to return to non-defaulted status even in a case where partial losses have been incurred on a specific exposure. This is, in particular, possible in the case of distressed restructuring where the loss could have been incurred at the moment of the restructuring. Such loss should not prevent a return to non-defaulted status where all conditions specified in that regard in the Guidelines are met. However, where the advanced IRB Approach is used these losses should be taken into account in the estimation of LGD.	No change
<b>Question 8: Do you agree with the proposed approach as regards the level of application of the definition of default for retail exposures?</b>			
	The large majority of respondents supported the proposed approach, especially with regard to alignment of the level of application of the definition of default with internal risk management practices. In addition, clarification was requested of paragraph 74 of the Consultation Paper, which requires keeping the number	The rules proposed for the level of application of the definition of default for retail exposures remained as specified in the Consultation Paper. It was not possible to provide more clarity on the possible level of overlap of obligors between portfolios subject to facility and obligor-level definitions of default and in particular it	No change



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	of clients under different levels of application of the definition of default to a strict minimum.	was not considered appropriate to specify a certain threshold in that regard. The extent of overlap should be assessed individually for each situation; however, the wording 'strict minimum' suggests that the extent of acceptable overlap should be limited to very few individual cases.	
<b>Question 9: Do you consider that where the obligor is defaulted on a significant part of its exposures this indicates the unlikelihood to pay of the remaining credit obligations of this obligor?</b>			
	The majority of respondents agreed that the pulling effect can be included as an additional, but not automatic, indication of unlikelihood to pay. Several respondents questioned the proposals for a possible automatic contagion rule based on additional indications of unlikelihood to pay in the case of default definition at the facility level. On the other hand, a few respondents suggested that the pulling effect should be mandatory and aligned with supervisory reporting requirement or that the threshold is too low.	Taking into account the concerns expressed by the respondents it was specified that the pulling effect could be taken into consideration as an additional indication of unlikelihood to pay but that this should not be an obligatory criterion for default.	No change
<b>Question 10. Do you agree with the approach proposed for the application of materiality threshold to joint credit obligations?</b>			
<b>Contagion rules</b>	Many respondents expressed general agreement with the proposed requirements. However, there was also a general opinion that automatic consideration of all individual obligors participating in a joint credit obligation as defaulted is too strict, especially in the case of many individual obligors. Several respondents suggested that a case-by-case assessment should be applied.	Taking into consideration the concerns expressed by the respondents, specific situations have been defined in paragraph 97 of the Guidelines where the default of a joint credit obligation does not have to lead to default of individual exposures to these obligors.	Par. 97



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<b>Competition</b>	Several respondents mentioned that competition issues may arise between Member States due to differences in materiality thresholds.	The concept of the materiality threshold and the way it applies have been harmonised through the RTS on the materiality threshold for past due exposures and these Guidelines. The right of the competent authorities to specify the exact level of the threshold has been granted by Article 178(2)(d) of the CRR and the differences between the Member States should reflect in particular different market and economic conditions in these countries.	No change
<b>Operational burden</b>	<p>Some respondents mentioned the operational burden in identification of those obligors that are within the scope of application of the joint default treatment, and also in terms of applying the treatment on a group-wide basis and criteria for the return to non-defaulted status.</p> <p>A few respondents argued that the identification of full joint liability of retail obligors (e.g. a married couple) on an ongoing basis is overly burdensome. Other respondents opined that consideration of contagion across retail and corporate exposures may not be possible and contradicts commonly applied management approaches. One respondent suggested that the alternative solution mentioned in the Consultation Paper (aggregating of individual and joint credit obligations) should be available for portfolios, for which the general approach is too costly or burdensome.</p>	As the implementation of some of the provisions included in the Guidelines may be challenging for some institutions, a long implementation period has been envisaged. As the relations between clients provide relevant information for the assessment of risk it is considered important that the institutions collect such information. However, where the full implementation of these requirements is overly burdensome and the effect of non-compliance is material, institutions may agree with their competent authorities appropriate action plans or demonstrate that the effect of non-compliance is immaterial on the basis of Article 146 of the CRR.	No change
<b>Default counting</b>	One respondent requested clarification of how default on a joint credit obligation should be counted in the default time series.	A joint obligor should be counted as a separate obligor. Therefore, default on a joint credit obligation should be counted separately from default of	No change



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
individual obligors.			
<b>Question 11. Do you agree with the requirements on internal governance for banks that use the IRB Approach?</b>			
	A large majority of the respondents agreed with the proposal. It was stressed by several respondents that it is important that the requirements be aligned with BCBS Guidelines on credit risk management processes. A few respondents mentioned possible difficulties with regard to the use test requirement, especially in the context of a large number of upcoming changes in the area of the IRB Approach.	The requirements on internal governance are based directly on the requirements for IRB institutions included in the CRR but they do not contradict BCBS guidelines. A long implementation period has been specified in order to account for the fact that during this period not only the changes in the definition of default will have to be implemented but in the case of institutions that use the IRB Approach also other changes related to the review of the IRB Approach.	No change