

# ***EBA Credit Risk:*** Definition of Default

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*Issues on the application of  
the default definition*

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## ***Contents***

Preface .....	5
Overview.....	9
Challenges.....	13
Solution .....	29

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# *Preface*

***On March 4th 2015 the European Banking Authority (EBA) published a discussion paper on the “Future of the IRB approach”. In this paper the EBA sets out the agenda for future improvements of the regulations in order to enhance the comparability of the internal risk estimates and capital requirements of European institutions and also to improve the transparency of the models and their outcomes.***

Based on previous reports prepared, the EBA identified several areas within the IRB that still showed a too high degree of flexibility in the application and also differences in the supervisory approaches with respect to the definition of default, PD and LGD calibration, treatment of defaulted assets and the use of the IRB.

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*EBA published both the final  
RTS and Guideline.*

As part of the work program laid out in the “Future of the IRB approach” EBA has published the following two documents:

- Final Report on Draft Regulatory Technical Standards (RTS) on the **materiality threshold for credit obligation past due** under Article 178 of Regulation (EU) 575/2013 from 28th September 2016 specifying the conditions according to which a competent authority shall set the materiality threshold for past due credit obligations in order to ensure consistency in the setting of the materiality threshold across the EU.
- Final Report on Guidelines on the **application of the definition of default** under Article 178 of Regulation (EU) No 575/2013 from 28th September 2016.

The report contains detailed clarification of the definition of default in order to harmonize the application across member states in the following areas:

- Days past due criterion
- Unlikelihood to pay
- External data
- Return to non defaulted status
- Consistency of the application
- Retail exposures
- Documentation and internal policies

.....  
*Assessment methodology for  
IRB approach*

In addition to these two EBA documents, additional information on the interpretation of the definition of default can be obtained from the final draft RTS on the **Assessment methodology for IRB approach**. This RTS will replace the previous CEBS's GL10 ('Guidelines on the implementation, validation and assessment of AMA and IRB approaches') and is aiming at harmonization of the supervisory assessment methodology for IRB approaches across all EU member states.

Kind regards,



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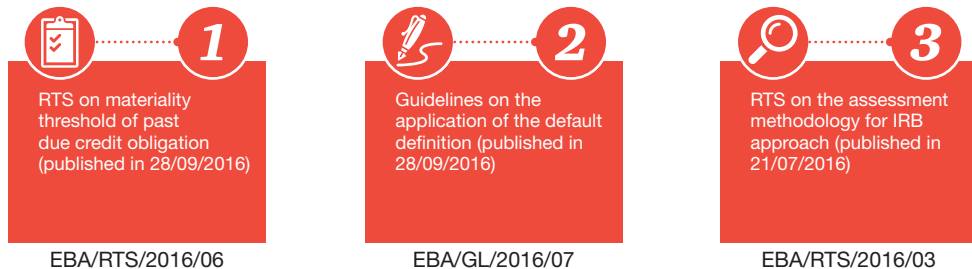
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# *Overview*

## Overview

What potential changes with respect to the definition of default do banks need to be aware of? As stated in the preface, the main regulatory developments on the interpretation of the default definition result from the three following EBA documents:

**Fig. 1 EBA Papers on default definition**



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**Fig. 2 Main topics in the EBA papers on default definition**

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Materiality threshold

- Conditions for national Supervisory Authority to set materiality thresholds
- Absolute and relative thresholds
- Aims to harmonize existing differences in application across the EU



Definition of default

- Detailed clarification of the definition of default and its application
- Covers several key aspects
- Aims to harmonize the definition of default and improve consistency and comparability how banks apply regulatory requirements to their capital positions



Assessment methodology

- Standards for the supervisor on the assessment of minimum IRB requirements
- Comprises the entire spectrum on IRB requirements
- Aims to ensure uniform interpretation and application of minimum IRB requirements by all relevant authorities



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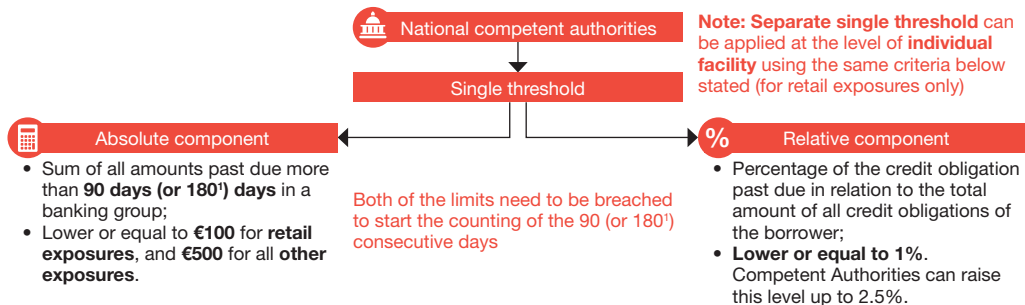
# *Challenges*

## RTS on the materiality threshold for past due credit obligations (EBA/RTS/2016/06)



Competent authorities define the nature of the thresholds, set the maximum level of the thresholds and define the implementation time:

Fig. 3 Materiality threshold for past due obligations



- Thresholds shall be applied no later than 31 December 2020 and remain consistent over time.
- Major impacts in the calculation of RWA/EL, and indirectly on other exposures through PD/LGD estimates.

<sup>1</sup> For exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to public sector entities.

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## ***Guidelines on the application of the definition of default under Article 178 CRR (EBA/GL/2016/07)***



The proposed definition of default addresses a wide range of topics. Mainly it proposes some **quantitative indications of default**:

- Level of application of the default definition for retail exposures
- Pulling and contagion effect for retail exposures
- Materiality threshold for retail and non-retail exposures

Some specific credit risk adjustments (SCRA) are mentioned as **qualitative indications of default** like:

- Distressed restructuring
- Sale of credit obligations
- Institute-specific indications of unlikelihood to pay

## Requirements on application article 178 of CRR on the definition of default



Past due criterion	Indications unlikeliness to pay	External data
<ul style="list-style-type: none"> <li>• <b>Counting of Days</b></li> <li>• <b>Sum of all amounts past due</b> on a group wide basis and a daily measurement</li> <li>• Avoidance of <b>technical default</b></li> </ul>	<ul style="list-style-type: none"> <li>• Non-accrued status</li> <li>• <b>Credit risk adjustments</b></li> <li>• Sale of credit obligations</li> <li>• <b>Distressed restructuring</b></li> <li>• Bankruptcy</li> <li>• <b>Other indications</b></li> <li>• <b>Governance process</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Alignment</b> of the internal vs. external default definition</li> <li>• <b>Quality</b> of associated documentation</li> <li>• <b>Assess impact</b> from conceptual differences</li> <li>• Apply <b>margin of conservatism</b></li> </ul>

Return to a non-default status	Consistency of application	Retail exposures	Documentation, internal policies, risk management
<ul style="list-style-type: none"> <li>• <b>Minimum conditions</b> for a <b>reclassification</b> to a non-defaulted status</li> <li>• <b>Monitoring of the effectiveness of the policy</b></li> </ul>	<ul style="list-style-type: none"> <li>• Ensure the default of a <b>single obligor</b> is <b>identified across all exposures and entities</b></li> <li>• <b>Default across different types of exposures</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Level of application</b> reflecting risk management practices</li> <li>• <b>Facility level</b> default indications, including implementing a pulling effect criterion</li> <li>• <b>Obligor level</b>, with relevance to the treatment of joint exposures</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Timeliness of the identification of default</b></li> <li>• Default definition policies</li> <li>• <b>Internal governance</b> (approval, validation and review)</li> </ul>



Past due criterion

Indications unlikeliness  
to pay

External data

- 1. Counting of days past due:** Harmonisation of the counting of days past due is predominantly achieved through the definition of the materiality threshold. However, if the credit arrangements allow the client to change the schedule, suspend or postpone the payments under certain conditions, the changed, suspended or postponed instalments should not be considered past due;
- 2. Sum of all amounts past due:** The sum of all amounts past due should be calculated on group basis with a frequency allowing timely identification of defaults, preferably on a daily basis. Information about the number of days past due and default should be up-to-date whenever it is used for decision making, risk management, reporting and capital requirements calculation;
- 3. Avoidance of technical default:** Criteria for a technical default are data or system error of the bank, result of the non-execution, defective or late execution of payment transactions ordered by the obligor, time lag between the receipt of the payment and the respective allocation to the relevant account and factoring arrangements where none of the receivables to the obligor is past due more than 30 days.

Return to a non-default status

Consistency of application

Retail exposures

Documentation, internal policies, risk management

**1. Specific credit risk adjustments:**

Banks should analyse the reasons for the sale (credit risk related or not?), quantify the economic loss (>5%?) and assess whether it is an individual sale or a portfolio sale;

**2. Distressed restructuring:** Banks have to define the scope of distressed restructured credits, quantify the level of diminished financial obligation (>1%?, considering the EIR at origination) and to set indicators that may suggest unlikelihood to pay notwithstanding the diminished financial obligation being lower than 1%;

**3. Other indications of unlikelihood to pay:** Banks should have in place specific documentation of additional indications of unlikelihood to pay and use available external databases (e.g. credit registers). They should also define conditions for a client cross default in a group of connected clients (contagious effect);

**4. Governance process:** Banks have to establish a consistent and effective application of the default definition (clear policies and procedures in place for all business lines, legal entities and geographical locations).



Past due criterion

Indications unlikeliness  
to pay

External data

1. **Alignment of the internal vs. external default definition:** The sample used for the purpose of the estimation of risk parameters has to be homogenous and representative of the institution's portfolio, including the definition of default that was applied;
2. **Quality of associated documentation:** Banks shall document sources of external data, the default definition used in external data, the performed analysis and all identified differences;
3. **Assess impact from conceptual differences:** Institutions should assess the differences between the definitions of default used internally and in external data as well as their impact on the default rate;
4. **Apply margin of conservatism:** Whenever banks are not 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, a margin of conservatism is to be added.



Return to a non-default status

Consistency of application

Retail exposures

Documentation, internal policies, risk management

1. **Minimum conditions:** No trigger continues to apply, specific treatment for distressed restructured exposures;
2. **Probation period:** Minimum of 3 month without any default trigger, different probation periods for different types of exposures, minimum of 1 year for distressed restructured exposures;
3. **Monitoring of the effectiveness of the policy:** Banks need to define clear criteria and policies for returning to non-default status and quantify the number of **multiple default cases**.



Past due criterion

Indications unlikeliness  
to pay

External data

1. **Consistent definition of default:** Use of different definitions of default across different exposure types or legal entities possible in very specific situations. Use of different definitions needs to be clearly documented and consistent with internal risk management practices;
2. **Consistent identification of default of single obligor:** Banks need to establish adequate procedures and mechanisms to ensure that the default of a single obligor is identified across all exposures in all legal entities and geographical areas (unless implementation is very burdensome and effect is immaterial).

Return to a non-default status

Consistency of application

Retail exposures

Documentation, internal policies, risk management

- 1. Level of application for retail exposures:** Definition of default on obligor level or facility level possible. Use of the level should reflect internal risk management practices, and clear specification of the scope of application of different default definitions in place;
- 2. Definition of default on facility level:** While the use of the default definition on facility level is possible, some indications of default are related with the condition of the obligor rather than the status of a particular exposure (e.g. bankruptcy) and need to be considered accordingly;
- 3. Definition of default on obligor level:** Clear definition for the treatment of joint exposures (two or more obligors equally responsible for the repayment of the obligation) required. Specific concept for recognising effects of single obligor defaults on joint exposures and default of joint exposures to other joint exposures required.



Past due criterion

Indications unlikeliness  
to pay

External data

Return to a non-default status

Consistency of application

Retail exposures

Documentation, internal policies, risk management

1. **Timeliness of the identification of default:** Timely default flagging (e.g. daily for automatic processes), and regular assessment of all forborne non-performing exposures;
2. **Documentation:** Banks need to document the default definition policies regarding all default triggers, entry and exit criteria, scope of application, sources of information, responsibilities/ownerships, return to non-default status (quarantine), operationalization processes (including updates, automatic ss. manual mechanisms), and updated register of all current and past versions;
3. **Internal governance:** Adoption of adequate processes to ensure that definition of default is used in a consistent manner. Internal Audit has to regularly review the robustness and effectiveness of the process for the definition of default.

## Challenges



In order to assess whether the institution effectively identifies all defaults in accordance with Article 178 of Regulation (EU) No 575/2013, competent authorities shall verify in particular the following:

Fig. 4 Main goals of RTS on the assessment methodology for IRB approach (EBA/RTS/2016/03)



1

#### Default triggers

- **Ensure adequate policy** is in place with regard to the counting of days past due;
- **All the default triggers are included;**
- **Scope of application is clearly specified** and differences justified for each definition of default when different definitions are used within or across legal entities.



2

#### Robustness and effectiveness

- All defaults are **identified in a timely manner;**
- Definitions and triggers of default are **sufficiently detailed;**
- Ensure that **once default is identified** for an obligor **all exposures to that obligor** are defaulted.



3

#### Reclassification to a non-default status

- **Triggers for reclassification are defined** for each trigger of default;
- **Reclassification** is possible only after **no trigger of default applies;**
- Triggers are sufficiently **prudent.**

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# ***Solution***



## ***Your solution: Our three phase approach***

We can help you respond to the upcoming regulatory changes. To anticipate unexpected impacts and preserve reputation we propose three phase approach.

**Fig. 5 PwC three phase approach**



***Step I:  
Review***



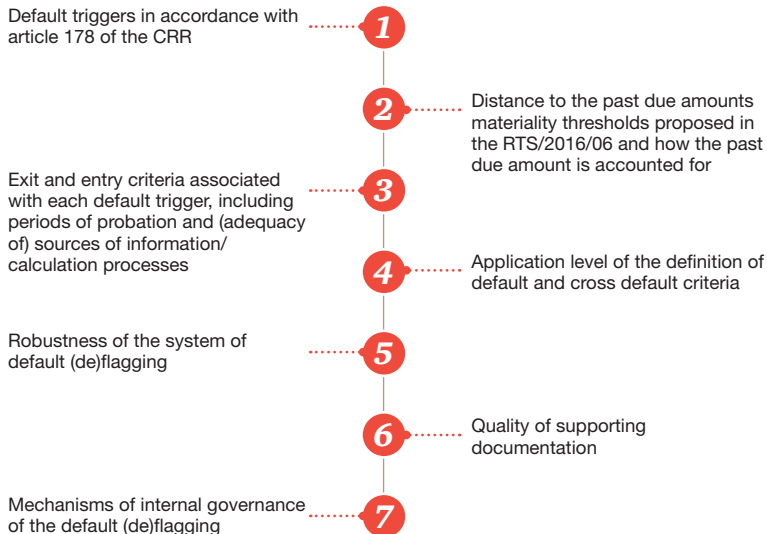
***Step II:  
Prepare &  
GAP-Tool***



***Step III:  
Implement***



**Fig. 6 Review phase**

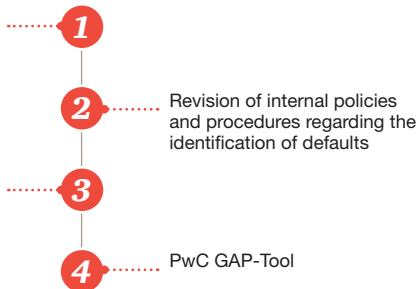




**Fig. 7 Prepare phase & GAP-Tool**

Detailed gap analysis of the actual default definition against EBA regulatory standards

Preparation of a material change application



The work of our international network for many of the largest global financial services firms provides us with significant exposure to leading practices. To design a GAP-Tool, PwC evaluated all received responses from participating financial institutions to each question of a consultation paper regarding definition of default and summarized them qualitatively and quantitatively, focusing on the respondents' key points.

**Executive summary**

**Background**  
The European Banking Authority (EBA) published consultation paper "Guidelines on the application of the definition of default under Article 178 of Regulation (EU) 2017/2402" and requested feedback on it. PwC evaluated all received responses from financial institutions participating in consultation and summarized them qualitatively and quantitatively into main messages with focus on the key points.

*This table lists the number of responses to each question offered. The possible answers were to the graphs to not sum up to the number of the responses.*

**The main findings:**

- For most proposals the respondents request **revision**
- In many cases the respondents request **alignment of expert judgement**
- The respondents emphasize that proposal needs to be **aligned with other regulation and accounting standards**

Page 2

**Question 1** The respondents agree with the proposed definition of technical default? The respondents who disagree should be included in the definition? Do you believe that other situations should be included in this definition?

**Definition of technical default is considered too restrictive**

**Do you agree with the proposed definition of technical default?**

**Do you believe that other situations should be included in this definition?**

**Main proposals of the CP**

- When identification of default includes more than one debt or IT and the alternative should be considered as technical default
- If request for payment has been made before maturity year the end reporting should not have been treated, such alternative should be considered as technical default
- Proposed banks to general practice the definition of technical default as too restrictive and too narrow, suggesting that criteria in their requirements set all possible cases of technical default are covered
- Also they emphasize that circumstances which are not related to the distribution of credit portfolio of the counterparty should not be a default, because of negative impact for PD and ECL calculations
- Participants also suggest that request for payment should not be a required part of the process of identification of technical default and should not solely rely on a third category of objective criteria the proposed by the EBA.

Page 3

**Question 5** The respondent request cash flows before and after discounting should be discounted with the current original discount rate when used for profit and loss calculation and when measuring cash flows before restructuring arrangement? Do you consider the specification of the interest rate to be mainly preferred?

**In the cases of restructuring original interest rate is mainly preferred**

**Should the original interest rate or interest rate before restructuring be used in discounting?**

**Is the specification of the interest rate used for discounting of cash flows clear?**

**Main proposals of the CP**

- The other alternative of technical default after the defaulting counterparty is that, to result in a technical default, the counterparty with current accounting method is not EBA's
- As decision align method with international accounting practice, an objective approach to technical default, with the requirement of the technical obligation type
- Responses from financial institutions are split into three categories:
  - Interest rate applicable at the moment before signing the arrangement
  - Original interest rate or an approximation thereof should be used
  - It should prefer the effective interest rate applicable at the moment before signing with current accounting method is not EBA's
- It should be clarifying obligation to use last transaction with EBA Act, 178 (2), (b)
- Technical debt to be measured by EBA, to completely covered or set by the financial institution, based on EBA

Page 4





### Fig. 8 Implement phase

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Calculation of the historical default rates and preparation of the inherent documentation

1

2

Estimation of potential impacts in terms of RWA, EL and NPE ratios

Propose monitoring mechanisms for the default rates and revise the current content of internal reporting on this subject

3

4

Implementation of the revised definition of default

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# *Contacts*

### *Our Expertise*

Whether regarding the Basel Committee, EU-regulation or national legislation – we use our established know-how of the analysis and implementation of new supervisory regulation to provide our clients with high-quality services. Embedded into the **international PwC network**, we have access to the extensive knowledge of our experts around the world.

**PwC's Global Basel IV Initiative** was established to support you in all aspects of getting compliant with the new regulatory requirements to the **definition of default**.

PwC can draw on long lasting experience of implementing new regulatory requirements by supporting a number of banks in completing quantitative impact studies prior to the implementation of **Basel II and Basel III** and by the functional and technical implementation of the final regulations. The PwC-tools used during the QIS are flexible and will be updated automatically in case of new consultations by the Basel Committee.



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