



NEW DEFINITION OF DEFAULT

The implementation is expected at the latest by end-2020 but institutions are encouraged to introduce the necessary changes as soon as possible.

CRR DEFINITION – THE DEFINITION INSTITUTIONS HAVE TO FOLLOW

Article 178(1) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR):

1. A default shall be considered to have occurred with regard to a particular obligor when either or both of the following have taken place:

(a) the institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security;

(b) the obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries. Competent authorities may replace the 90 days with 180 days for exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to public sector entities). [...]

MAIN COMPONENTS TO BE CONSIDERED

1. **Past due criterion in the identification of default** (Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013, chapter 4)
 1. Counting of days past due
 2. Technical past due situation
 3. Exposures to central governments, local authorities and public sector entities
 4. Factoring and purchased receivables
 5. Materiality threshold
2. **Indications of unlikeness to pay** (Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013, chapter 5)
 1. Non-accrued status
 2. Specific credit risk adjustments
 3. Sale of the credit obligation
 4. Distressed restructuring
 5. Bankruptcy
 6. Other indications
3. **Conditions for a return to non-defaulted status** (Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013, chapter 6)
4. **Treatment of the definition of default in external data** (Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013, chapter 7)

THE MAIN SOURCES OF VARIABILITY IN DEFAULT DEFINITION USED IN PRACTICE

The results of the analysis presented in QIS report (Quantitative Impact Study, RESULTS FROM THE DATA COLLECTION EXERCISE ON THE PROPOSED REGULATORY CHANGES FOR A COMMON EU APPROACH TO THE DEFINITION OF DEFAULT) indicate that the greatest variability of practices is observed in these areas:

1. Materiality threshold: In half of the cases where an institution uses more than one definition of default, the differences stem from the materiality threshold. Furthermore, a significant variation is observed with regard to both the structure and the levels of materiality thresholds in use.
2. Distressed restructuring: The practices among institutions show the greatly different interpretations of distressed restructuring as an indication of unlikelihood to pay.
3. Probation period: The qualitative analysis shows that half of the banks apply probation periods at least partially, while the other half do not use probation period at all, or only for distress restructuring. In addition to this, there is a wide range of lengths of probation periods among those institutions that use them.

Maybe your institution uses a significantly different definition of default than it should use according to the guideline. In such case you will probably need to implement significant changes in methodology. We can help you with this.

You can contact us at info@quantitative.cz

REFERENCES

The Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013 clarify all aspects related to the application of the definition of default.

The Draft Regulatory Technical Standards on the materiality threshold for credit obligations past due under Article 178 of Regulation (EU) No 575/2013 specify the conditions for setting the materiality threshold for credit obligations that are past due and harmonise the structure and application of the threshold, which will entail an absolute and a relative component.

The QIS report (Quantitative Impact Study, RESULTS FROM THE DATA COLLECTION EXERCISE ON THE PROPOSED REGULATORY CHANGES FOR A COMMON EU APPROACH TO THE DEFINITION OF DEFAULT) presents detailed information about the current practices of institutions with regard to key aspects of the definition of default and provides an estimated impact of selected policy scenarios on the capital requirements and capital adequacy ratios of the institutions.