



DRAFT GUIDELINES ON THE DEFINITION OF DEFAULT

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Guidelines on default definition – introduction

- This CP provides clarification on the application of Article 178 of the CRR as required by Article 178(7) of this Regulation.
- Consultation Paper on the Guidelines on the application of the definition of default (EBA/CP/2015/15) has been published on 22 September 2015 for 4 months consultation period. Comments to this consultation can be sent to the EBA by 22 January 2016.
- Simultaneously a QIS was launched to assess the likely impact of the most important policy options included in the draft Guidelines.
- Although it is expected that the Guidelines will have biggest impact on IRB firms they will also have an effect on the use of the Standardised Approach.
- Final Guidelines will take into consideration the results of the QIS and industry's feedback received in the consultation period.

Background

- The Guidelines on the definition of default is part of the broader EBA work related to the review of the IRB Approach as described in the Discussion Paper on the Future of the IRB Approach (EBA/DP/2015/01) published in March 2015. The planned EBA work in this area is summarised in the table below:

Prioritisation	Regulatory products	Current status
Phase 1: Assessment methodology	RTS on IRB assessment methodology	Finalisation stage
Phase 2: Definition of default	RTS on materiality threshold GL on default of an obligor	Consultation stage
Phase 3: Risk parameters	GL on PD estimation GL on LGD estimation GL on treatment of defaulted assets RTS on downturn conditions	Preparation stage
Phase 4: Credit risk mitigation	RTS on conditional guarantees RTS on liquid assets RTS on master netting agreements	Planning stage

Guidelines on default definition – main policy options

Days past due criterion

- Consistency with the RTS on materiality threshold
- Definition of technical default – errors in data, IT systems and processes or lengthy payment allocation processes

Indications of unlikelihood to pay

- Specific credit risk adjustments
 - All SCRA except IBNR indicate default
 - IFRS 9 – exposures classified as ‘Stage 3’
- Sale of credit obligations – default when economic loss is related with credit quality and the loss is material i.e. higher than specified threshold
- Distressed restructuring
 - Definition based on forbearance
 - Loss based on comparison of discounted cash flows
- Other indications of unlikelihood to pay
 - Should reflect characteristics of different types of exposures
 - Should include the treatment of connected clients

Guidelines on default definition – main policy options

Default definition in external data

- Only for IRB Approach
- Broad equivalence with the internal definition of default
- Where necessary – additional margin of conservatism

Criteria to return to non-defaulted status

- Minimum probation periods for days past due criterion:
 - Starting when indications of default cease to apply
 - At least 3 months
- Minimum probation periods for distressed restructuring
 - Starting from the latter of: (i) restructuring contract, (ii) default identification, (iii) end of grace period
 - At least 1 year
 - Material payment made by the obligor during the probation period
- Monitoring policies to avoid excessive number of multiple defaults

Guidelines on default definition – main policy options

Consistency of default definition

- Possibility to use different default definitions for different types of exposures where justified
- Consistent identification of default of a single obligor within an institution and the group

Retail exposures

- Consistent level of application of default definition across the group, unless there are no or very few common clients
- Default contagion rules for joint credit obligations

Governance

- Documentation requirements including a register of default definitions
- Additional requirements for IRB firms regarding internal governance, use test and internal audit



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