Guidelines on the application of the definition of default and RTS on the materiality threshold

European Banking Authority (EBA)

www.managementsolutions.com

List of abbreviations

Abbreviation	Meaning
CA	Competent Authority
CRR	Capital Requirements Regulation
DO	Diminished financial obligation
EBA	European Banking Authority
GL	Guidelines
IRB	Internal Ratings-Based
NPV	Net present value
QIS	Quantitative Impact Study
RTS	Regulatory Technical Standards
SCRA	Specific credit risk adjustments
UTP	Unlikeliness to pay

Index

Introduction

In September 2016 the EBA published final Guidelines on the application of the definition of default and Regulatory Technical Standards on the materiality threshold of past due credit obligations. Both documents are intended to harmonise the definition of default across the EU

Introduction

The Capital Requirements Regulation (CRR) establishes the definition of default of an obligor that is used for the purpose of the IRB Approach and for the Standardised Approach for credit risk. However, in the absence of specific rules in this regard, the EBA has identified differing practices used by institutions when applying the definition of default.

- In this context, the EBA published in September 2016 the following documents:
  - **Guidelines** (GL) specifying the **application of the definition of default**, which clarify aspects regarding the past due criterion, the indications of unlikeliness to pay (UTP), the criteria for the return to a non-defaulted status, etc.
  - **Regulatory Technical Standards (RTS) on the materiality threshold** of past due credit obligations, which specify the conditions that competent authorities (CAs) shall apply when setting the materiality threshold for credit obligations.
- Both the GL and the RTS will **harmonise the definition of default** across the EU.
- Along with these documents, the EBA published the results of a **Quantitative Impact Study (QIS)** aimed at assessing the impact on the regulatory capital requirements of selected policy options to harmonise the definition of default.

This document includes an **analysis of the requirements** arising from the Guidelines and the RTS, and also an assessment of the **implications** for institutions.

Index

Executive summary

On the one hand, the GL clarify aspects related to the past due criterion, the indications of unlikeliness to pay, the criteria for the return to a non-defaulted status, etc. On the other hand, the RTS specify the conditions that CAs shall apply when setting the materiality threshold

Executive summary

Scope of application	Regulatory context	Next steps
• **Credit institutions and investment firms** (institutions) under the scope of the CRR, with regard to the definition of default used for the purpose of the Standardized Approach for credit risk and the IRB Approach.	• Article 178 of **Regulation (EU) No 575/2013** on capital requirements (CRR).	• The implementation of the GL and of the RTS is expected at the latest by **end-2020**. In the case of **IRB institutions**, the implementation should be based on **individual plans** agreed with their CAs.

Main content

GL on the application of the definition of default

- **Past due criterion**. The GL clarify aspects with regard to the counting of days past due, the technical past due situation, etc.
- **Indications of UTP**. Guidance is provided regarding the application of each indication (bankruptcy, distressed restructuring, etc.).
- **Application of the definition of default in external data**. Certain requirements are specified for institutions that use the IRB Approach and use external data for the purpose of estimating risk parameters.
- **Criteria for the return to a non-defaulted status**. The probation period and the minimum conditions for reclassification to a non-defaulted status are specified (including specific rules applying to exposures subject to distressed restructuring).
- **Consistency**. It is specified that institutions should identify the default of a single obligor consistently, and also that institutions may use different definitions of default for certain types of exposures, although differences have to be justified.
- **Definition of default for retail exposures**. The GL clarify aspects with regard to the level of application (e.g. credit facility level).
- **Documentation and internal governance**. The GL include some documentation requirements, and also governance requirements for IRB institutions.

RTS on the materiality threshold

- **Materiality threshold**. CAs are required to set a threshold for retail and for 'non-retail', which will apply to all institutions in a given jurisdiction. The RTS require that this threshold is composed of both an absolute and a relative threshold.

ManagementSolutions
Making things happen

Index

GL on the application of the definition of default

Past due criterion

The GL provide clarification on certain situations in relation to the counting of days past due. Moreover, they also specify the definition of technical past due situation

Past due criterion (1/2)

Counting of days past due

- A credit obligation is past due where any amount of principal, interest or fee has not been paid at the date it was due. In this regard, these GL clarify the following situations:
  - Where the credit arrangements explicitly allow the obligor to **change the schedule, suspend or postpone** the payments, the changed, suspended or postponed instalments should **not be considered past due**[1]. The counting of days past due should be based on the new schedule once it is specified.
  - Where the repayment of the obligation is **suspended** because of a **law** allowing this option, the counting of days past due should **also be suspended** during that period[1].
  - 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**[2].
  - Where the **obligor changes due to an event** (e.g. merger) the counting of days past due should start from the moment the **different person or entity becomes obliged** to pay the obligation.
- Institutions should ensure that the **information** about the days past due and default is **up-to-date** whenever it is being used for certain purposes (e.g. internal risk management, own funds requirements calculation, etc.).
- The classification of the obligor as defaulted should **not be subject** to additional **expert judgement**. Once the obligor meets the past due criterion (and breaches the materiality threshold) **all exposures** to that obligor are **defaulted**, unless either of the following conditions is met: i) exposures are eligible as **retail exposures** and the definition at **individual credit facility** is applied; ii) there is a '**technical past due situation**'.

Technical past due situation

- A technical past due situation should only be considered to have occurred in any of the following cases:
  - The defaulted status was a result of **data or system error** (excluding wrong credit decisions).
  - The defaulted status was a result of a **failure of the payment system** (e.g. non-execution).
  - Due to the nature of the transaction, the **payment was made before the 90 days** and the **crediting** in the client's account took place **after the 90 days past due**.
  - For **factoring arrangements**, where the purchased receivables are recorded on the balance sheet, the materiality threshold has been breached, but none of the receivables is past due more than 30 days.

(1) Nevertheless, institutions should analyse if there are changes in these situations and assess the possible indications of UTP.
(2) Subject to the occurrence of at least one of certain conditions (e.g. dispute introduced to a court).

GL on the application of the definition of default

Past due criterion

Also with regard to the past due criterion, the GL specify certain aspects related to the treatment of exposures to central governments, local authorities and public sector entities, as well as some issues regarding factoring and purchased receivables and the materiality threshold

Past due criterion (2/2)

Treatment of certain exposures

- Institutions may apply a specific treatment for exposures to **central governments**, **local authorities** and **public sector entities** where all of the following conditions are met:
  - The contract is related to the **supply of goods and services** and the **administrative procedures** require certain controls related to the execution of the contract before the payment can be made[1].
  - **No other indications of UTP** are applicable, the financial situation of the obligor is sound and there are no reasonable concerns that the obligation might not be paid in full.
  - The obligation is **past due** no longer than **180 days**.
- Institutions that decide to apply this treatment should **neither** include these exposures in the calculation of the **materiality threshold** for other exposures to this obligor **nor consider them as defaults**. Moreover, they should be **clearly documented** as exposures subject to the specific treatment.

Factoring and purchased receivables

- A differentiation is 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.
  - Where individual receivables are recognised on the balance sheet, the **risk weight** will apply to these **individual receivables**. 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.
  - 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. Such an account should be treated as past due where a client breaches the advised limit once the account is in debit.
- Events related to **dilution risk** (e.g. discounts) should not be considered events of default.

Materiality threshold

- CAs should notify the EBA of the levels of the materiality thresholds that they set in their respective jurisdiction. Where CAs set the relative component at a level **different than 1%** (i.e. relative threshold specified in the RTS) they should provide justification for this different level to the EBA.
- Institutions may use **lower thresholds** than those specified by CAs as **additional indications of UTP**.

(1) The delay in payments results only from these procedures.

GL on the application of the definition of default
Indications of unlikeliness to pay

The GL provide clarification on the application of each indication of UTP[1]: non-accrued status, specific credit risk adjustments (SCRA), sale of a credit obligation…

Indications of unlikeliness to pay (1/2)

Non-accrued status

- 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.

SCRA[2]

- The following SCRA should be treated as an indication of UTP:
  - Losses recognised in the **profit or loss account** for instruments measured at **fair value** that represent **credit risk impairment** under the applicable accounting framework.
  - 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.
- The SCRA that cover '**incurred but not reported losses**' should **not be considered** an indication of UTP.
- Where the institution treats an exposure as **impaired** such a situation should be considered an **additional indication of UTP** and hence the obligor should be considered **defaulted** (except in the case of incurred but not reported losses).
- Where the institution treats an exposure as **credit-impaired under IFRS 9** (stage 3), such exposure should be considered **defaulted**, although there are exceptions (i.e. the exposure has been considered credit-impaired due to the delay in payment and at least one of the conditions specified in the GL is met).

Sale of the credit obligation

- Institutions should consider the following aspects when determining whether the sale is an indication of UTP:
  - **Character**. Where the reasons for the sale were **not related to credit risk**, the economic loss is **not a indicator** of default[3]. Otherwise, the materiality of the loss should be assessed.
  - **Materiality**. Institutions should set a **threshold** for the credit-related economic loss which **should not be higher than 5%** (calculated as specified in the annex). Where the economic loss is higher than this threshold they should consider the credit obligations **defaulted**.

(1) Moreover, institutions should have clear policies on the application of the criteria for UTP.
(2) If the institution uses both IFRS 9 and another accounting framework, it should choose how to classify exposures as defaulted in accordance with the GL and apply this choice consistently over time.
(3) Subject to documented justification of the treatment of the sale loss as not credit-related.

GL on the application of the definition of default

Indications of unlikeliness to pay

…distressed restructuring, bankruptcy and other additional indications of UTP that should be specified by institutions in their internal policies

Indications of unlikeliness to pay (2/2)

Distressed restructuring

- 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[1]. The obligor should be considered **defaulted** where the distressed restructuring is likely to result in a **diminished financial obligation**.
- Institutions should set a **threshold**, which **should not be higher than 1%** (calculated as specified in the annex), for the **diminished financial obligation** that is considered to be caused by material forgiveness or postponement of principal, interest, or fees:
  - Where it is **higher** than this threshold, the exposures should be considered **defaulted**.
  - If it is **below the 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, institutions should assess such exposures for other possible indications of UTP[2]. The indicators that may suggest UTP include irregular repayment schedule, significant grace period, etc.
- Any concession to an obligor already **in default** should lead to classify the obligor as a **distressed restructuring**. Exposures classified as **forborne non-performing** should be classified as **default** and subject to distressed restructuring.

Bankruptcy

- Institutions should specify in their **internal policies** what type of arrangement is treated as bankruptcy, considering all relevant **legal frameworks** and some typical **characteristics**. It is specified that all types of arrangements listed in Annex A of Regulation 2015/848 have to be treated as bankruptcy.

Other indications of UTP

- Institutions should specify in their **internal policies** other additional indications of UTP. The occurrence of an additional indication of UTP should either result in an **automatic reclassification** to defaulted exposures or trigger a **case-by-case assessment**.
- The GL include a **non exhaustive list** of possible indications of UTP that could be considered by institutions (e.g. a borrower's sources of recurring income are no longer available to meet the payments).

(1) According to Annex V of Regulation 680/2014 of European Commission.
(2) Where the institution has reasonable doubts with regard to the likeliness of repayment in full of the obligation according to the new arrangement, the obligor should be considered defaulted.

GL on the application of the definition of default

Application of the definition of default in external data

Institutions that use the IRB Approach and external data for the purpose of estimation of risk parameters should apply the requirements specified below

Application of the definition of default in external data

Assessment of the definition used in external data

- IRB institutions that use external data for the purpose of estimation of risk parameters should:
  - Verify whether the definition of default used in the external data is **in line with the CRR**.
  - Verify whether the definition of default used in the external data is **consistent** with the **definition of default as implemented by the institution** for the relevant portfolio of exposures (including the counting and number of days past due, the structure and level of the materiality threshold, etc.).
  - **Document** sources of external data, the default definition used in external data, the performed analysis and all identified differences.

Differences in the definition of default

- For each difference identified in the definition of default resulting from the previous assessment, IRB institutions should:
  - 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.
  - 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.
- Regarding the totality of the differences identified, institutions should be able to demonstrate to CAs that **broad equivalence** with the internal definition of default **has been achieved**, including where possible a comparison of the **default rate** in internal data on a relevant type of exposures with external data.
- Where the assessment identifies differences in the definition of default which are 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**.

GL on the application of the definition of default

Criteria for the return to a non-defaulted status

The GL specify the probation period (i.e. 3 months) and the minimum conditions for reclassification to a non-defaulted status, including specific minimum conditions and a different probation period (i.e. 1 year) for exposures subject to distressed restructuring

Criteria for the return to a non-defaulted status

Minimum conditions

- Institutions should (except where distressed restructuring apply to a defaulted exposure):
  - Consider that no trigger of default continues to apply to a previously defaulted exposure, where **at least 3 months**[1] have passed since the moment that the **conditions of default cease to be met**[2].
  - Take into account the **behaviour** and the **financial situation** of the obligor during the 3 months period.
  - After the 3 months period, perform an **assessment** and where the institution still finds that the obligor is unlikely to pay its obligations in full, the exposures should continue to be classified as defaulted[2].

Distressed restructuring

- 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:
  - The moment of **extending the restructuring measures**.
  - The moment when the exposure has been **classified as defaulted**.
  - The **end of the grace period** included in the restructuring arrangements.
- Institutions should reclassify the exposure to **non-defaulted status** after at least the **1 year period** where all of the following conditions are met:
  - During that period a **material payment** (i.e. equal to the amount that was previously past-due or that has been written-off under the restructuring measures) has been made by the obligor[2].
  - The **payments** have been made **regularly** according to the schedule applicable after the measures[2].
  - There are **no past due credit obligations** according to the schedule applicable after the measures[2].
  - **No indications of UTP** or any additional indications of UTP specified by the institution apply[2].
  - The institution considers it **likely that the obligor will pay its credit obligations** in full according to the schedule after the measures without recourse to realising security[2].

Monitoring of effectiveness of the policy

- Institutions should define clear **criteria and policies** regarding: i) when it can be considered that the improvement of the financial situation is sufficient to allow the full and timely repayment; and ii) when the repayment is actually likely to be made even where there is an improvement in the financial situation.
- Institutions should **monitor on a regular basis** the **effectiveness** of these policies. In the case of extensive number of multiple defaults of obligors that returned to non-default recently, institutions should **revise** them.

(1) Institutions may apply different periods for different types of exposures.
(2) This condition should be met also with regard to new exposures to the obligor.

GL on the application of the definition of default
Consistency

Institutions should adopt adequate mechanisms and procedures in order to ensure that the definition of default is implemented consistently

Consistency

Identification of a single obligor

- Institutions should implement adequate procedures 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 the **exchange of client data** among different entities within an institution is **prohibited** by regulation (e.g. consumer protection) resulting in inconsistencies, institutions should inform their CAs. Moreover, if they use the IRB Approach, they should also **estimate the materiality** of the inconsistencies and their possible **impact** on the estimates of risk parameters.
- Where the consistent identification of default of an obligor across the institution is very **burdensome** (e.g. requiring development of a centralised database of all clients) institutions do not need to apply such mechanisms or procedures if they can **demonstrate** that the **effect of non-compliance is immaterial**.

Across types of exposures

- Institutions may use **different definitions of default** for different types of exposures where this is justified by several reasons (e.g. different materiality thresholds set by CAs in their jurisdictions).
- Where different definitions of default are applied either across types of exposures, the institutions' internal procedures relating to the definition of default should ensure:
  - That the **scope of application** of each definition is clearly specified.
  - 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.
  - 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 whose scope of application encompasses different default definitions.

GL on the application of the definition of default

Application of the definition of default for retail exposures

Institutions should choose the level of application of the definition of default for all retail exposures in a way that reflects their internal risk management practices. Depending on the level of application chosen, institutions should comply with certain requirements

Definition of default on retail exposures

Retail exposures

- Under the CRR, 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. In this regard, the GL specify that they should choose the level for all retail exposures in a way that reflects their **internal risk management practices**.
- 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** (if it is justified). In this case, institutions 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[1].
  - Specify in their **internal policies** the treatment of **common clients across portfolios**.

Facility level

- Where 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. However, they should take into account some **indications of default**:
  - In particular, where the **indication of bankruptcy** of default occurs, institutions should treat all exposures to the same obligor as **defaulted** regardless of the level of application.
  - Additionally, where a significant part of the exposures to the obligor is in default, institutions may consider the other obligations defaulted (**pulling effect**) as an additional indication of UTP.

Obligor level

- The application of the definition of default at the obligor level implies that, where any credit obligation of the obligor is defaulted, all exposures to that obligor should be considered **defaulted**. Institutions applying this level should specify rules for the treatment of **joint credit obligations** in their **internal policies**.
- If any of the **indications of default** occurs on[2]:
  - A joint credit obligation, all other joint credit obligations of the same set of obligors and all individual exposures to those obligors should be considered defaulted (although there are exceptions).
  - 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.

(1) In the case of IRB institutions, the risk estimates should correctly reflect the definition of default applied to each type of exposures.

(2) For the purpose 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.

GL on the application of the definition of default

Documentation and internal governance

Finally, the GL include several requirements related to documentation and the timeliness of the identification of default. Moreover, for IRB institutions, specific requirements with regard to internal governance are given

Documentation and internal governance

Timeliness of identification of default

- 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 it in the shortest possible time, where possible in an **automated manner**[1], to the personnel that is responsible for taking credit decisions.
- 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 UTP.
- **Control mechanisms** should ensure that the relevant information is used immediately after being obtained.

Documentation

- Institutions should document their **policies** regarding the definition of default, including all **triggers for identification**, the **exit criteria** and clear identification of the **scope of application**. In particular, they should:
  - Document the operationalisation of all **indications of default** and of the criteria for reclassification to a **non-defaulted status** (e.g. automatic mechanisms and manual processes, sources of information, etc.).
  - Keep an **updated register** of all **definitions of default** (including aspects such as the scope of application, the body approving each definition, the date of implementation of each definition, etc.).

Internal governance (IRB)

- Institutions that use the **IRB Approach** should ensure that:
  - The definition of default and the scope of its application are **approved by the management body**, or by a committee designated by it, and **by senior management**.
  - 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** (being used at least in the area of monitoring of exposures and in the internal reporting to senior management and management body).
  - The **internal audit unit reviews** regularly the robustness and effectiveness of the process used by the institution for the **identification of default**, ensuring that the conclusions of the internal audit's review and respective recommendations, as well as the measures taken to remedy the weaknesses, are communicated directly to the **management body** or the committee designated by it.

(1) Where they apply automatic processes, the identification of indications of default should be performed on a daily basis.

Index

RTS on the materiality threshold

The CRR mandates the EBA to develop RTS in order to specify the conditions that CAs should consider when setting the materiality threshold. In this regard, the RTS specify that the materiality threshold shall be composed of an absolute and a relative value

Materiality threshold

Materiality threshold

- CAs are required to set a threshold for **retail** and for all other ('**non-retail**') exposures, which will apply to all institutions in a given jurisdiction. The RTS require that this threshold is composed of both an **absolute and a relative threshold**.
- In setting the threshold, CAs shall take into account the **risk characteristics** of exposures.

Absolute threshold

- The absolute threshold refers to the **sum of all past due amounts** related to the credit obligations of the borrower towards the institution, the parent undertaking or any of its subsidiaries.
  - For **retail exposures**, the absolute threshold cannot be higher than **100€**.
  - For **non-retail exposures**, the absolute threshold cannot be higher than **500€**.

Relative threshold

- The **relative threshold** is defined as a **percentage of a credit obligation past due** in relation to the total on-balance-sheet exposures to the obligor excluding equity exposures.
  - For **both retail and non-retail exposures**, the relative threshold should be **set at the level of 1%**. Nonetheless, if a CA considers that this level does not reflect a reasonable level of risk[1] it may set a relative threshold at a different level, which in any case must be **lower than or equal to 2.5%**.

Breach of the threshold

- In the case where **both of those limits are breached** for 90 consecutive days (or 180 days if the CA has decided to replace it in accordance with the CRR) a **default** would be considered to have occurred.

(1) CA shall consider that the level of risk is reasonable where the level of the threshold does not lead to recognition of an excessive number of defaults that result from other circumstances than financial difficulties, or to significant delays in the recognition of defaults that result from financial difficulties.

Index

Implications

The implications arising from the implementation of the GL and the RTS are related to governance, the classification of exposures as defaulted, internal policies and impact on capital requirements and on parameters and models

Implications

Governance (for IRB institutions)

- The definition of default and the scope of its application are required to be approved by the **management body** (or by a committee) and by **senior management**.
- Moreover, the definition of default should be used at least in the **area of monitoring of exposures** and in the **internal reporting** to senior management and the management body.
- Finally, the **internal audit unit** should review regularly the robustness and effectiveness of the process used for the identification of default.

Classification of exposures as defaulted

- Institutions should **adapt** their **methodologies and systems**. Thus, among others, institutions should:
  - Implement the specifications regarding the **past due criterion** and the **indications of UTP**.
  - Adjust the **probation period** to 3 months (1 year in the case of distressed restructuring).
  - Adapt the **materiality threshold** to the level set by CAs.
  - Ensure **consistency** in the identification of a single obligor.

Internal policies

- Institutions should review their internal policies and procedures in order to **include certain aspects** that should be defined. In particular, institutions should specify other additional **indications of UTP**, what types of arrangements are treated as **bankruptcy**, the treatment of **joint exposures** (e.g. contagious effect), etc.
- Moreover, they should comply with the **documentation requirements.**

Impact on capital, and on parameters and models

- As the changes in the definition of default may result in **reclassifications of non-defaulted exposures as defaulted**, institutions should **monitor the impact** on capital requirements for credit risk.
- Institutions should **recalibrate their risk parameters** (PD, LGD and EAD), or at least assess the impact[1], which may result in the need to **adapt the systems** as it is necessary to redefine the historical data of default.

(1) For some portfolios, the impact may be insignificant. In those cases there is no need to update the risk parameters and models.

Index

Next steps

The implementation of the Guidelines and of the RTS is expected at the latest by end-2020. In the case of IRB institutions, the implementation should be based on individual plans agreed with the competent authorities

Next steps

- The implementation of the Guidelines and of the RTS is expected at the latest by **end-2020**, although institutions are encouraged to introduce the necessary changes as soon as possible.
- In the case of **IRB institutions**, the implementation should be based on **individual plans** agreed between institutions and their competent authorities.

Index

Annex 1

Indications of UTP – thresholds set by institutions

For the purpose of assessing the materiality of the economic loss in the sale of a credit obligation and the diminished financial obligation in the case of distressed restructuring, institutions should set thresholds calculated according to the specifications below

Indications of UTP – thresholds set by institutions

Sale of the credit obligation

- The threshold should be calculated according to the **following formula** (and should not be higher than 5%):

$$L = \frac{E - P}{E}$$

Economic loss related with the sale of credit obligations

Price agreed for the sold obligations

Total outstanding amount of the obligations subject to the sale, including interest and fees

- Institutions should calculate the economic loss and compare it to the threshold. Where the **economic loss is higher than this threshold** they should consider the credit obligations **defaulted**.
- The sale of credit obligations may be performed either **before or after the default**.
  - If the sale 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, all the **remaining exposures** to this obligor should be treated as **defaulted**[1].
  - In the case of **IRB institutions**, regardless of the moment of the sale, the **information about the loss** should be adequately **recorded** for the purpose of the estimation of risk parameters.

Distressed restructuring

- The threshold should be calculated according to the **following formula** (and should not be higher than 1%):

$$DO = \frac{NPV_0 - NPV_1}{NPV_0}$$

Diminished financial obligation

NPV_1 is net present value of the cash flows expected based on the new arrangement[2]

NPV_0 is net present value of cash flows expected under contractual obligations before the changes in terms and conditions[2]

- For each distressed restructuring, institutions should calculate the DO and compare it with the threshold. Where the **DO is higher than this threshold**, the exposures should be considered **defaulted**. If however the DO is below the threshold, institutions should assess such exposures for **other possible indications of UTP**.

(1) Unless the exposures are retail exposures and the institution applies the definition at facility level.
(2) Discounted using the customer's original effective interest rate.