

New EBA definition of default

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Need for action for all banks

Reform of the regulatory framework for the definition of default according to Article 178 CRR

Urgent need for action

- ▶ Adaption of systems and processes for the detection of default (**CRSA*** and **IRBA**), including processes for unlikelihood to pay
- ▶ Harmonizing historical data with the new definition of default → early start for gathering data history
- ▶ Recalibration of PD, LGD, and CCF
- ▶ Model change for IRB models

*Credit Risk Standard Approach

Changes in parameters

- ▶ Default rate (PD) 
- ▶ Loss rate (LGD) 
- ▶ Risk provisions 
- ▶ Risk weights 
- ▶ Return on equity 

Recommended measures

- ▶ Full validation of models
- ▶ Adaption of internal controls
- ▶ Adaption of risk strategy
- ▶ Adjustment of competence system
- ▶ Revision of risk governance
- ▶ Current IRBA applications reflect new requirements

- ▶ Do you have a plan to ensure compliance by **31 December 2020**, including building sufficient data history?
- ▶ Have you already identified all affected areas, models and processes?
- ▶ Have you already defined measures to mitigate the expected impact, e.g., on soft collection?
- ▶ Are you aware of interdependencies to other implementations, such as IFRS 9?

Past Due Criterion as an indicator of default

1

Counting of days past due

Counting the past due days to consider default according to Article 178(1) of Regulation No 575/2013.

Count starts after non payment of any of the financial obligation (Principal, interest, fees)

Exceptions for the count: Legislative, contractual agreement, disputes in the justice court.

2

Technical Past due situations

Says explicitly the cases when the default should not be considered even though the past due criterion was triggered.

- Data system error
- Failure of payment transaction order
- Time lag of transaction
- Factoring specifics

3

Exposures to central government, public sector and local authorities

Sets some lower standards for the exposures (except Bonds) offered to government and public sector.

4

Factoring and purchased receivables

Specifies the measurement against absolute and relative materiality threshold.

Sets rules of treatment of events related to dilution risk.

Clarifies the technical details in case of cession of the receivables from factors clients.

5

Materiality threshold

Competent authorities should identify materiality threshold suitable for them.

Relative threshold is suggested to be 1% but could be up to 2.5% if it is argued by competent authorities

Absolute amount Threshold 100 and 500 EUR for retail and non retail respectively

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Counting the DPD

- Under some contractual agreements (change of schedule) the DPD count may be re-adjusted. Unlikelihood to pay should be assessed.
- The DPD count is suspended in case of a dispute until it is resolved. 2 situations are possible:
 - 1. Dispute in the court (legal)
 - 2. In case of leasing – complaint addressed to the company, and recognized by internal audit, internal validation or other independent audit department.
- DPD count restart in case of M&A
- DPD counting moment should reflect the moment of default.
- The Default is not subject to expert judgement. If the criteria are fulfilled, it should be considered defaulted

Past Due Criterion as an indicator of default

2

Technical Past due situations

Says explicitly the cases when the default should not be considered even though the past due criterion was triggered.

- Data system error
- Failure of payment transaction order
- Time lag of transaction
- Factoring specifics

Technical Past Due situations

- Technical Past Due criteria can be applied in one of the following cases:
 - default status was attributed because of a data error
 - Non execution/ late/ wrong execution of a payment order. Or failure of payment system
 - Nature of the account supposes a time lag
 - In case of factoring: the purchased receivables are on the BS of the institution, but payments to the obligor is not more than 30 DPD.
- In case of IRB Technical Pas Due cases should be removed from the data set prior to estimation of risk parameters.

Past Due Criterion as an indicator of default

3

Exposures to central government, public sector and local authorities

Sets some lower standards for the exposures (except Bonds) offered to government and public sector.

Central Government and public sector exposures

- Specific treatment may be applied when the following are met :
 - Contract is subject to administrative procedures that require some control before payment is made: factoring exposures.
 - No indication of unlikelihood to pay
 - DPD<180
- If the specific treatment is applied then institutions should also :
 - Exclude the exposures in the calculation of the materiality threshold for other exposures to the obligor
 - Not treat them as defaulted
 - Clear documentation has to be arranged

Past Due Criterion as an indicator of default

4

Factoring and purchased receivables

Specifies the measurement against absolute and relative materiality threshold.

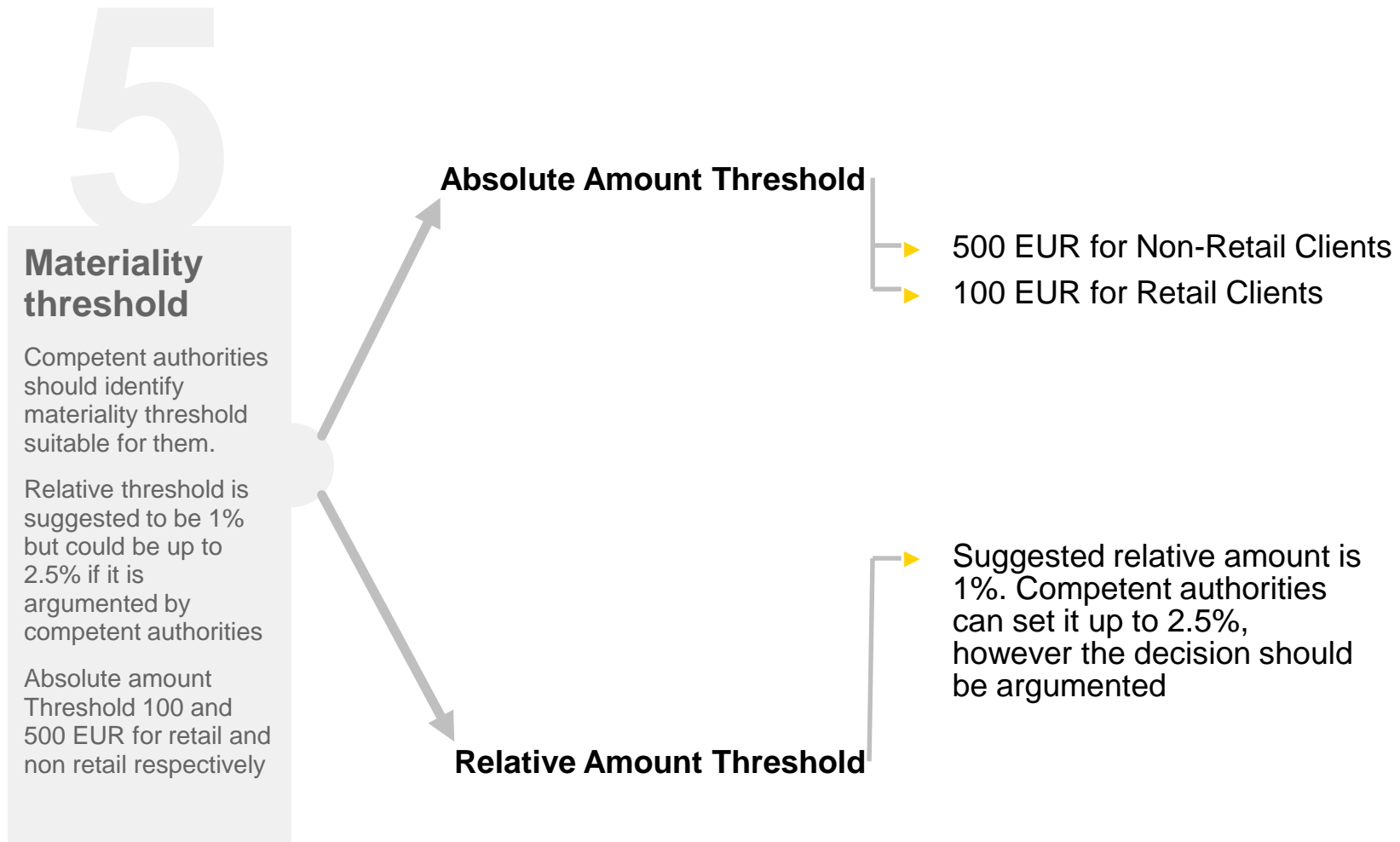
Sets rules of treatment of events related to dilution risk.

Clarifies the technical details in case of cession of the receivables from factors clients.

Factoring and purchased receivables

- When the receivables are not recognized on the BS of the factor and factor is directly liable to client, the DPD starts when the factoring account is in Debt. The factor should assess the materiality of factoring and other obligations on the absolute and relative threshold.
- When the receivables are recognized in the BS, the counting of DPD should start when one single obligation is due.
- In the event of dilution, the diluted amount should be included in the calculation of DPD.
- When the payment by client was wrongly made to the initial company. If the client was not informed then DPD should not be counted. If it was informed and still made the payment wrong DPD should be counted.

Past Due Criterion as an indicator of default



Indicators of unlikeliness to pay

With reference to Article 178(3) of Regulation (EU) 575/2013

01

Non Accrued status

Interest from the obligor is not recognized in the Income Statement as a result of decrease in the credit quality..

02

SCRA

Specific Credit Risk Adjustment

Gives guidance on what to consider as SCRA. Mainly treatment of losses connected to the obligation. Provides guidance of exceptions of SCRA recognition.

03

Sale of the asset

Sale of the credit obligation

Institutions should assess the character and the materiality of the sale. Losses from sale should be assessed and if appropriate default status should be applied.

04

Distressed Restructuring

Indicates how restructuring should be treated in comparison with default. Restructured obligation increases concern. In case forbearance is likely to result, should be classified as default if diminished financial obligation breaches threshold (1%).

05

Bankruptcy

Institutions should indicate in their policies what types of arrangements can be treated similar to bankruptcy

06

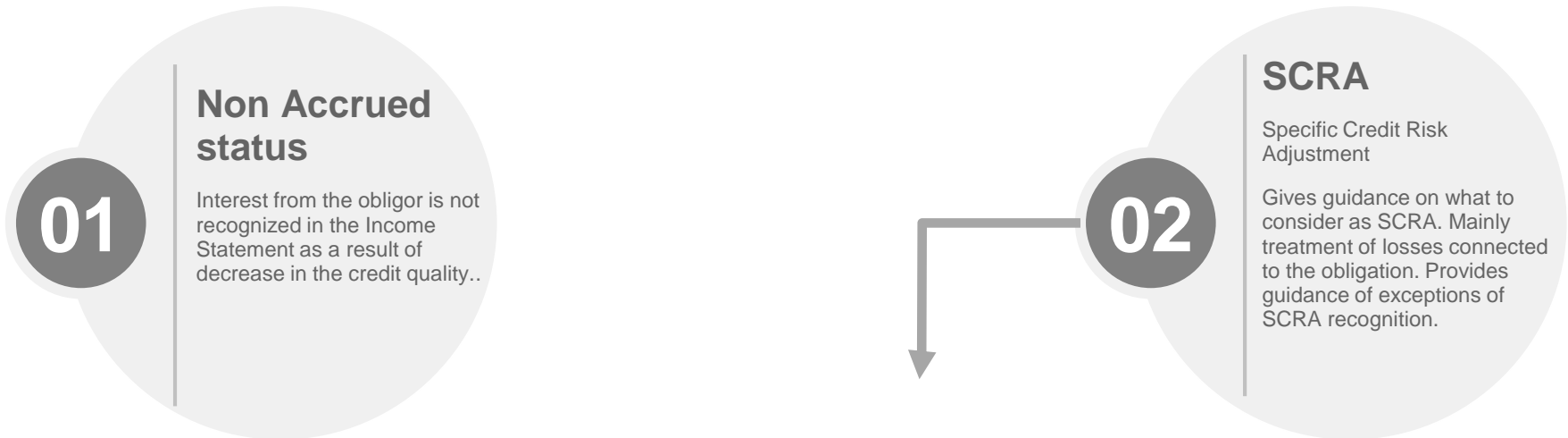
Other

Gives guidance on what information institutions should include in the assessment to develop other indicators of unlikeliness to pay. Include:

- Assessment of source of income
- Breaching other credit contracts
- Info in external data bases

Indicators of unlikeliness to pay

With reference to Article 178(3) of Regulation (EU) 575/2013



- ▶ Institutions may consider as indicators of unlikeliness to pay losses recognized in P&L that are attributed to CR deterioration for fair valued instruments
- ▶ Losses from a current or past event which affect significant individual or non significant exposures.
- ▶ If the institution is not aware which exposure has suffered the loss , should not be considered as an indicator of unlikeliness to pay
- ▶ If the exposure is impaired, this is an indication of unlikeliness to pay and hence defaulted, however for incurred and not reported loss this is not applicable
- ▶ Credit impaired exposures under IFRS9 should not be considered defaulted when:
 - ▶ Competent authorities have recognized 180DPD as appropriate limit
 - ▶ Threshold has not been breached
 - ▶ Special Treatment exposure (Government)

Indicators of unlikelihood to pay

With reference to Article 178(3) of Regulation (EU) 575/2013

03

Sale of the asset

Sale of the credit obligation

Institutions should assess the character and the materiality of the sale. Losses from sale should be assessed and if appropriate default status should be applied.

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

Where:

- ▶ E – outstanding amount including interest and fees
- ▶ P – price agreed for sale
- ▶ L – economic loss

- ▶ The economic loss which is associated with Sale of the assets from reasons other than credit risk should not be considered as indication of default.
- ▶ If the economic loss is material and is attributed to decrease in credit quality this can be an indication of default.
- ▶ The materiality threshold is 5% of the total outstanding amount, including interest and fees, if it is breached then the obligation should be considered defaulted
- ▶ For IRB's the info on defaulted sales also should be included in risk parameter estimation
- ▶ For obligations that default was identified after the sale, the moment of the sale is considered the moment of default. The remaining obligations of the same obligor are considered defaulted.
- ▶ If the price was set on the portfolio level, the materiality threshold should be assessed and if it is breached, all the exposures are considered defaulted.

Indicators of unlikeliness to pay

With reference to Article 178(3) of Regulation (EU) 575/2013

04

Distressed Restructuring

Indicates how restructuring should be treated in comparison with default. Restructured obligation increases concern. In case forbearance is likely to result, should be classified as default if diminished financial obligation breaches threshold (1%).

- ▶ The obligation should be considered defaulted when the forbore loan is to result in diminished financial obligation.
- ▶ The threshold for forbearance should be set according to the formula and equal or lower than 1%. If the diminished financial obligation is higher than the threshold, it should be considered defaulted.
- ▶ If below the threshold, unlikeliness to pay should be assessed. Following could be considered indicators of unlikeliness to pay:
 - ▶ Large lump up payment at the end of the repayment schedule
 - ▶ Irregular payments with low payments in the beginning
 - ▶ High grace period
 - ▶ Restructuring occurred multiple times

$$D0 = \frac{NPV0 - NPV1}{NPV0}$$

Where:

- ▶ D0 – diminished financial obligation
- ▶ NPV0 – net present value of CF's before restructuring, using original EIR
- ▶ NPV1 – net present value of CF's after restructuring, discount used original EIR

Indicators of unlikelihood to pay

With reference to Article 178(3) of Regulation (EU) 575/2013



Annex A to Regulation (EU) 2015/848 – list of insolvent procedures in each EU country



- ▶ The sources of recurring income are no longer available to meet the payments of instalments.
- ▶ Call of the collateral including guarantee
- ▶ Increase in the borrowers leverage level
- ▶ Significant part of the borrower's retail exposures are defaulted
- ▶ Delays in other payments outside of institutions frame
- ▶ Sectoral crisis or disappearance of the market, legal issues etc.
- ▶ Fraud indications.

Return to non-defaulted status

01

Minimum conditions for re-classification

Gives general and technical guidance for the return to non-default status as well some exceptions from the rule.

Some examples:

- 3 M since the conditions of default are not met anymore and 12 M for distressed restructured loans from the time of default, extension of restructuring or grace period
- Behavior analysis
- Financial analysis

02

Monitor the effectiveness

Institutions should monitor regularly the returned to non-default status clients. It is expected to have a low re-default rate.

Return to non-defaulted status



- ▶ No default trigger applies at least 3 months
- ▶ Behavioral analysis of the obligor
- ▶ Analyse the financial situation of the obligor
- ▶ The condition of non default or return to non default should be assessed for other exposures of the obligor

- ▶ Reclassification is done after 1 year of no default trigger applicable since the moment of extending restructure, classification of default or end of grace period in the restructuring.

All of the following should apply

- ▶ Material payment has been made according to the new schedule
- ▶ Payments have been made regularly
- ▶ No past due obligations
- ▶ No indicators of unlikeliness to pay
- ▶ Institution does not consider the client being unlikely to pay the full amount
- ▶ All the above condition should be met by the new exposures of the obligor.

Return to non-defaulted status



- ▶ The institution should identify clear criteria when an obligor should be transferred to non default status. Mainly :
 - ▶ When it is considered that the financial situation improved
 - ▶ When the payment is likely to be made
- ▶ The institution should analyze the effectiveness of the policies and monitor:
 - ▶ Change of the status of obligors or individual facilities
 - ▶ Impact on Cure Rate
 - ▶ Impact of the policies on multiple defaults

▶ It is expected that institution should have a limited nr of re-defaulting cases. Otherwise it should revise the policies

Consistency in the application of the definition of default

1

The same definition or the same scope

Within the institutions of the same group, the same definition of default should be used for all the same type of assets.

2

The information on defaults have to be shared among institutions

The default of one obligor should be reflected among businesses within the group. If the information sharing is legally protected, the institution should inform the competent authorities. If the effect of this process is immaterial the institution can skip it.

3

Exceptions can be

In some cases the institutions are allowed to have different definitions of default if this is justified by the special legal framework requirements or special risk management practices applicable in the region:

1. Different materiality thresholds set by authorities in the jurisdiction
2. Use of 180 DPD instead of 90 in some jurisdictions for IRB approach
3. Other unlikeliness to pay specific for special legal entities, exposures or locations

Differences with IFRS 9

1

Credit impaired (Stage 3)

Generally all of them should be considered defaulted, however some exception may apply (>DPD180)

2

Stage 2

The fact that they are stage 2 should not mean that they are defaulted. Only if there is evidence of unlikeliness to pay otherwise they don't breach the DPD

3

90+ DPD in IFRS

The GL specifies that its threshold is DPD 91. IFRS is reporting standard so should be possible to use 91 if justified with prudential reasons.

4

Non Accrued Status

Not part of IFRS and not very specific. However where the accounting framework does not cover it, it won't occur.

5

POCI

For the purpose of the GL, only the unlikeliness to pay can be an indicator of them being in default.

EY supports throughout all phases of implementation

Implementation of target regime

Scope: Implementation of the new definition of default, full review and adaption of models, full update of regulatory reporting, adjustments of credit processes and controls

Duration: Several phases over the span of four years

First tactical implementation

Scope: Start-up of historical analytical data review, good-proxy review and adaption of models for IRB roll-out/IFRS9/stress testing purposes, refined RWA impact simulations

Duration: 6 months

Feasibility Assessment and Design

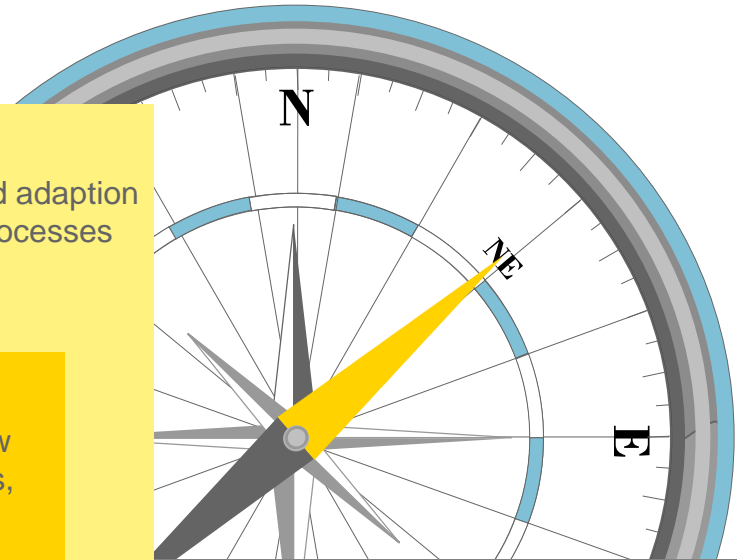
Scope: Preparation of implementation (RWA-analysis, identification of necessary adjustments)

Duration: six weeks

Workshops

Scope: Discussion of the regulatory requirements and agenda for assessment/design

Duration: 0.5-1 days



Possible focus of feasibility assessment and design

- ▶ RWA impact analysis
- ▶ GAP-assessment of IT implementation
- ▶ GAP-assessment of historical data for model re-calibration
- ▶ High-level design of model, process and IT updates
- ▶ Prioritizations and plan for implementation



Q/A ?



The better the question. The better the answer.
The better the world works.



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