New definition of default

What banks need to do by the end of 2020

Minds made for transforming financial services

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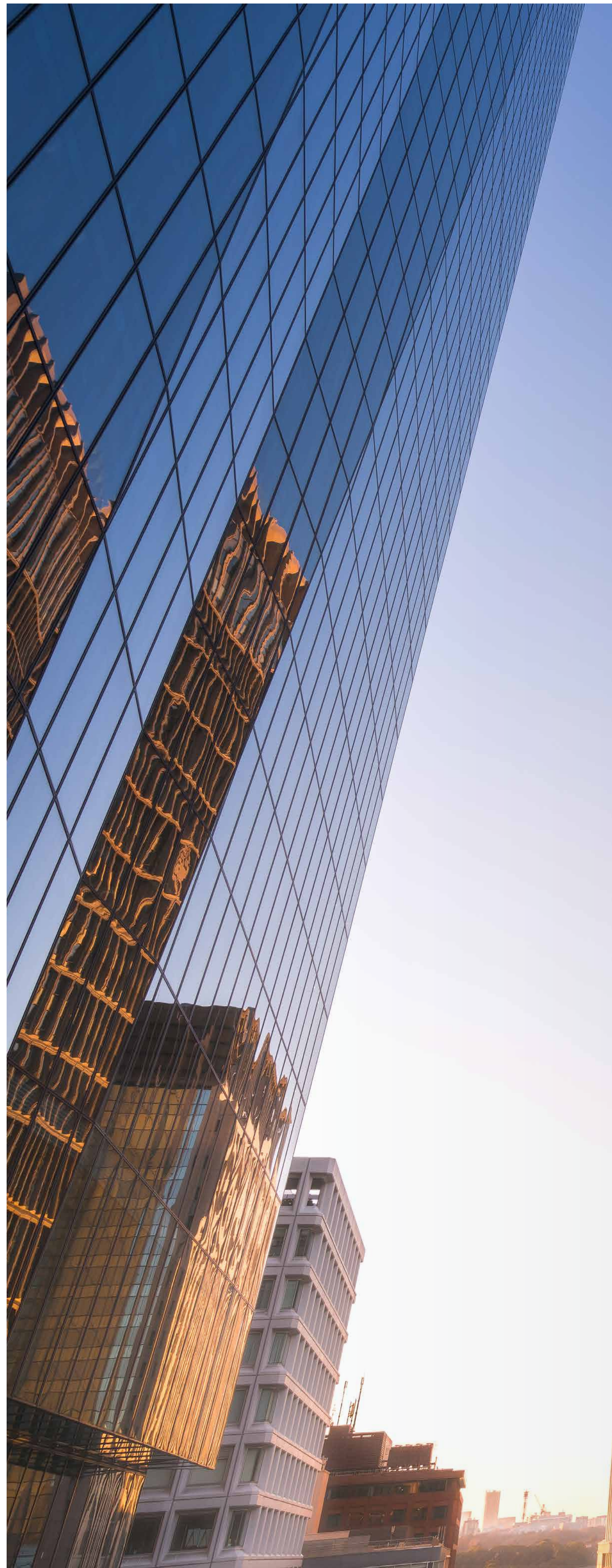


Following the financial crisis, the European Banking Authority (EBA) has established tighter standards around the definition of default (CRR Article 178) to achieve greater alignment across banks and jurisdictions. These need to be implemented by the end of 2020.

European regulators have adopted new detailed standards on how banks need to recognize credit defaults for prudential purposes to increase consistency across countries and banks. The deadline for compliance is the end of 2020.

Banks that have carried out a quantitative impact analysis have found that the new standards can materially impact the number and timing of defaults, calling into question the validity of existing models and processes. The impact varies significantly across banks (depending on approach for estimating regulatory capital and pre-existing default definition) as well as across individual portfolios within the banks. But where the impact is material it needs to be reflected in updated risk management and supporting decisions (e.g., pricing), accounting (e.g., IFRS9, Effective Interest Rate) and capital models (IRB and ICAAP).

The guidelines are extensive and detailed, challenging legacy IT infrastructure and processes that have often evolved organically over the years. For some banks this is an opportunity to cleanse historical data, refresh and modernize supporting infrastructure, and establish the foundation of a more sustainable data strategy to support advanced analytics. New processes and controls also need to be established.

But time is short and the changes, considered material for all capital models, require substantial efforts from both banks and regulators alike. IRB banks subject to ECB supervision have already had to submit detailed impact assessments and implementation plans as part of the model re-approval process. All IRB models also need to be updated to reflect additional changes introduced by the EBA as part of the 'IRB repair work', by the end of 2021. But progress across the industry is far from uniform and some national regulators have been less engaged with the banks they supervise.

Furthermore, these changes are only a few among a series of ongoing challenges, such as refining IFRS9 implementation, meeting ongoing demands to improve stress testing capability and implementing Basel III reforms. This leaves banks, and supervisors, with a lot to do and little time to do it.

In this paper we provide a summary of the new regulation, and highlight points for consideration based on the challenges banks have faced so far in their implementation efforts. At the end of this paper we also reference a list of relevant publications and a "New DoD on a page" summary of the new definition of default (DoD) standards.

Regulatory overview

What is the new DoD and what does it mean?

- A new set of standards that are more detailed and prescriptive, and will have significant impact on governance, data, processes, systems and credit models.
- The impact on capital requirements depends on several influencing factors, including type of approach for estimating capital requirements (IRB or Standardised Approach), current implemented default definition and portfolio specifics.
- For approved IRB capital models, the new standards are deemed to be a material change and hence requiring formal re-approval of a Competent Authority, irrespective of capital impact.
- All banks need to implement the new standard by 31 December 2020 for reporting to start 1 January 2021.

What are the new guidelines?

- European Banking Authority (EBA) guidelines on the application of the definition of default.
- European Commission (EC) regulation on the materiality threshold for credit obligations past due.
- National Competent Authorities (NCAs) and ECB have published their own consultation papers and policies where the regulation provides national discretion (materiality thresholds and 180 days past due).

Who does it impact?

- All firms subject to the Capital Requirements Regulation (CRR) and holding capital against credit activities.
- IRB banks need to recalibrate their credit models but banks under the Standardised Approach (SA) also need to identify, use and report defaults according to the new DoD.

What are other relevant publications to consider?

- New requirements for internal models that must be developed and implemented by the end of 2021, e.g., EBA guidelines for estimating Probability of Default (PD) and Loss Given Default (LGD); 'IRB Repair'.
- The broader regulatory reform agenda, specifically Basel III finalization and forthcoming regulation (CRR2/CRR3), as it impacts the model landscape and capital beyond 2021.
- Regulations on the definition and/or management of forborne and non-performing exposures, notably guidelines from the EBA and the Basel Committee on Banking Supervision (BCBS).
- The EBA, ECB and NCAs have also published additional guidance and impact assessments related to the new DoD.
- See ***Publications*** at the end of this paper for an extended list of references to relevant publications.

Summary of the new rules

01

Days past due (DPD)

Materiality thresholds

Introduction of new absolute and relative materiality thresholds for the purposes of DPD counting; when both thresholds have been breached for 90 days, a default has occurred. ECB and most NCAs have adopted the EBA RTS thresholds:

- Retail: 1% relative and €100 absolute
- Non-retail: 1% relative and €500 absolute

The notable exception to this being the PRA in the UK which has adopted a 0% relative and a zero absolute threshold for retail exposures to minimize the operational impact that changing the widespread practice of determining 90 DPD through a 'months-in-arrears' approach would imply. It should be noted that NCAs outside the Eurozone have adopted absolute thresholds in local currency; these have so far been specified in even amounts broadly equivalent to €100 and €500. Where banks apply default at obligor level, they should ensure materiality thresholds are also applied at obligor level. Banks may opt to use lower thresholds as an additional unlikeliness to pay trigger (see below).

Past due amount and DPD counting

The amount past due shall be the sum of all amounts past due, including all fees, interest and principal. For the relative threshold, this amount should be divided by the total on-balance exposure. In case the principal is not repaid or refinanced when an interest-only loan expires, DPD counting should start from that date even if the obligor continues to pay interest.

There are also specific requirements for when DPD counting may be stopped – when the credit arrangement specifically allows the obligor to change the schedule, when there are legal grounds for suspended repayment, in case of formal legal disputes over the repayment or when the obligor changes due to a merger or similar event.

Technical default

The standards specify a strict and limited set of so called technical defaults, i.e. false positives that are caused by technical issues; generally data or system errors, or failures or delays in recognizing payment.

Removal of 180 DPD

Following the EBA recommendation to remove the CRR option to use 180 DPD instead of 90 DPD (as applicable under the rules for residential and SME commercial real estate and/or exposures to public sector entities), ECB has removed this option for Systemically Important Institutions (SIIs) in the Single Supervisory Mechanism (SSM) and all NCAs that have previously exercised the CRR option to allow 180 DPD have followed suit.

Factoring and purchased receivables

Specific requirements for factoring and purchased receivables; where a factor does not recognize the receivables on its balance sheet, DPD counting should start when the client account is in debit, otherwise DPD counting should start from when a single receivable becomes due.

02

Unlikeliness to pay (UTP)

Non-accrued status

UTP will be triggered if the credit obligation is put on non-accrued status under the applicable accounting framework.

Specific Credit Risk Adjustment (SCRA)

Added guidelines on cases where SCRAs trigger UTP.

Sale of the credit obligation

The sale of a credit obligation needs to be assessed and classified as defaulted if the economic loss exceeds 5%.

Distressed restructuring

Concessions extended to obligors with current or expected difficulties to meet their financial obligations should be considered distressed restructurings. These need to be assessed to establish materiality; if the net present value (NPV) of the obligation decreases by more than 1% (or a lower threshold set by the institution), the obligation should be considered defaulted.

Bankruptcy

Clarification on arrangements to be treated similar to bankruptcy, including but not limited to all arrangements in annex A of Regulation (EU) 2015/848 on insolvency proceedings. This includes not only such arrangements directly involving the institution but also such arrangements the debtor has with third parties.

Additional indications of unlikeliness to pay

Banks must define additional UTP indicators.

The standards specify additional UTP indications that must be included, e.g., fraud. The standards also provide guidance on optional UTP indications to be considered, e.g., significant increase in obligor leverage, significant delays in payment to other creditors, etc.

Furthermore, they specify situations when these and other UTP triggers should be evaluated, e.g., in the event the obligor changes the repayment schedule within the rights of the contract.

03

Return to non-default status

Probation periods

Minimum regulatory probation period of 3 months for all defaults with the exception of distressed restructuring, where a 1 year minimum probation period applies.

Banks have to monitor the behavior and financial situation of the obligor in probation to support cure after the probation period expires. There is an option for banks to apply different probation periods to different types of exposures (as long as they meet the minimum requirement). In case the defaulted exposure is sold, the bank needs to ensure the probation period requirements are applied to any new exposure to the same obligor.

Monitoring the effectiveness of the policy

Banks are required to monitor the appropriateness of their curing policy on a regular basis, including impact on cure rates and impact on multiple defaults.

04

Other key changes

External data

When external data is used for the estimation of risk parameters, the institution must document the DoD used in these external data, identify differences to the institution's internal definition, and perform required adjustments in the external data for any differences identified, or demonstrate that such differences are immaterial.

Consistency in the application of default

Banks must ensure that the default of an obligor is identified consistently across IT systems, legal entities within the group, and geographical locations. If this is prohibited due to legal limitations on information sharing, competent authorities must be notified. Additionally, for banks using the IRB approach, they need to assess the materiality of impact on risk estimates. Where the development of this capability is burdensome, banks will be exempt if they can demonstrate immateriality due to few shared obligors with limited exposures.

Furthermore, the internal definition of default must be applied consistently across legal entities within the group and across types of exposures, unless the bank can justify differences on the basis of different internal risk management practices or different legal requirements. Such differences must be clearly specified and documented.

Level of DoD application and contagion

The standards provide guidance on DoD application at facility and/or obligor level for retail exposures.

Generally, when a credit obligation defaults which is related to an exposure where default applies at obligor level, all other exposures of the obligor should also default, including those where the institution applies default at facility level. When a credit obligation defaults which is related to an exposure where default applies at facility level, the institution should only consider other exposures of the obligor in default for certain UTPs.

Timeliness of default identification

Institutions should have automated processes, where possible, that identify defaults on a daily basis. Where this is not possible, manual processes must be performed frequently enough to ensure timely identification of defaults. Delays in recording defaults must not lead to errors or inconsistencies in risk management, risk and capital calculations or internal/ external reporting.

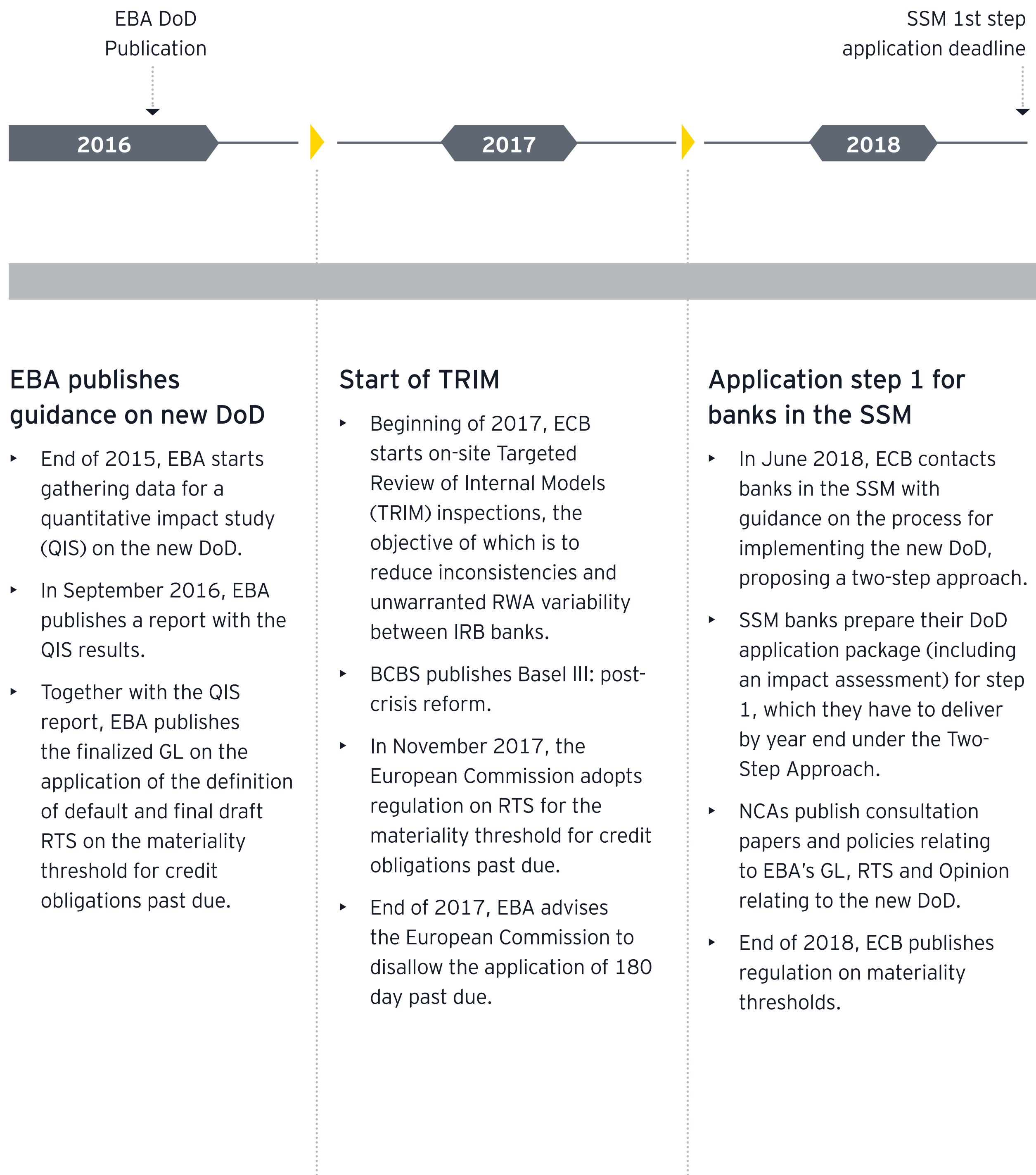
Documentation

Banks must document all their internal DoDs in use, including associated scope, and triggers for default and cure. They also need to keep an updated register of all historic versions of DoDs used. Furthermore, banks must document how the default and cure logic is operationalized in detail, including governance, processes, and information sources for each trigger.

Internal governance requirements for IRB banks

Additional governance requirements are introduced for banks using the IRB approach, e.g., the requirement that Internal Audit should regularly review the robustness and effectiveness of the process of identifying defaults.

Timeline



EBA publishes guidance on new DoD

- End of 2015, EBA starts gathering data for a quantitative impact study (QIS) on the new DoD.
- In September 2016, EBA publishes a report with the QIS results.
- Together with the QIS report, EBA publishes the finalized GL on the application of the definition of default and final draft RTS on the materiality threshold for credit obligations past due.

Start of TRIM

- Beginning of 2017, ECB starts on-site Targeted Review of Internal Models (TRIM) inspections, the objective of which is to reduce inconsistencies and unwarranted RWA variability between IRB banks.
- BCBS publishes Basel III: post-crisis reform.
- In November 2017, the European Commission adopts regulation on RTS for the materiality threshold for credit obligations past due.
- End of 2017, EBA advises the European Commission to disallow the application of 180 day past due.

Application step 1 for banks in the SSM

- In June 2018, ECB contacts banks in the SSM with guidance on the process for implementing the new DoD, proposing a two-step approach.
- SSM banks prepare their DoD application package (including an impact assessment) for step 1, which they have to deliver by year end under the Two-Step Approach.
- NCAs publish consultation papers and policies relating to EBA's GL, RTS and Opinion relating to the new DoD.
- End of 2018, ECB publishes regulation on materiality thresholds.

2019 | 2020 | 2021 | 2022 and beyond

New DoD basis of reporting from 1 January 2021

Time until DoD go-live

Feedback from ECB

- Early 2019, SSM banks receive feedback from ECB on their submitted application package. A number of SSM banks are requested to modify parts of their self assessment.
- Halfway through 2019, ECB delivers feedback on the permission to use the Two-Step Approach to SSM banks that have applied for this. Negative feedback may result in exemption from the Two-Step Approach.
- If SSM banks have received permission, they will focus on default definition go-live (step 1), leaving enough time to collect one year of default data under the new default regime.

New DoD standards operationalized

- Adjustments to systems and processes to take into account the new DoD should be implemented and taken into production.
- Banks build up data history based on the new DoD to support model redevelopment.
- Some national regulators may propose different timelines for model updates, e.g., in the UK the PRA latest consultation has proposed that residential mortgage models should be updated and implemented by the end of 2020, with other IRB models due by end of 2021. This is taking advantage of the flexibility afforded under the IRB framework under article 146.

Models updated for new DoD and IRB repair changes

- Material models updated to reflect new DoD and 'IRB repair' standards by end of 2021, to go live from 1 January 2022.
- Models that are no longer eligible for IRB under revised Basel III framework can be de-prioritized to end of 2023, or banks can apply for permanent partial use.
- Where models have not been redeveloped or approved, scalars/capital buffers may apply.

Basel III go-live

- The revised Standardised Approach for credit risk and revised IRB framework should be implemented as of 1 January 2022 (Basel framework timelines).
- The output floor starts at 50% and will increase to 72.5% in 2027.
- Adjustments of business models to the new regulatory regime.

Key challenges and considerations

Jurisdictional alignment

NCA discretions on materiality thresholds could lead to complexities for banking groups with cross border entities in the EU. At this time, we expect jurisdictional differences to be limited — the main difference currently arising in the UK, where PRA has set zero thresholds for retail exposures to accommodate the 'months-in-arrears' approach to determine 90 DPD defaults.

Similar challenges arise for global banks that need to decide whether to extend any changes to current practices in their EU entities to entities outside of the EU (including e.g., how to handle materiality thresholds for portfolios denominated in different currencies).

Impact assessment

A quantitative impact assessment is an important step in understanding the broad implications of the new standards on the capital position, individual businesses and associated models. As such it also informs:

- Policy decisions where some flexibility and choices exist: this includes adopting lower DPD materiality thresholds, contagion of facility level retail exposure defaults ('pulling effect') and other additional indications of UTP triggers as well as different probation periods.
- Scalars to ensure capital estimates reflect the new standard for models that are not redeveloped and approved by 2021.
- Priorities for model updates.

Banks ideally have the historical data to assess impacts on level, timing and duration of defaults, with associated impacts on cures. Where historical data is not sufficiently rich, banks have to adopt a range of approaches to support the analysis, ranging from historical data cleansing and recasting, to simulation based approaches or qualitative assessments. Where the impact cannot be estimated with a high level of confidence, focus is on accelerating process updates to collect default data on the new standards.

Where banks use external data, which is common for wholesale models, they will need to demonstrate its consistency with updated internal standards.

Knock-on impact on the broader model universe

In the run-up to 2022, a number of additional regulatory changes ('IRB repair') are being implemented to capital models together with the new definition of default standards. These cover requirements around margins of conservatism, realized losses, long run average or hybrid calibration, and downturn calibration for LGD and EAD. Regulators are expecting all these changes to be incorporated in banks' IRB remediation programs.

Changes to the definition of default also impact the broader model stack across risk, finance and treasury analytics (e.g., IFRS9, Fund Transfer Pricing, stress testing), raising important planning and prioritization challenges to banks. It also stretches resources

that are already facing substantial demands from increased model risk management standards, IFRS9 day 2 activities, CECL implementation (for some), while progressing with AI and machine learning strategies, among other changes. This is prompting some banks to reconsider the broader model universe and how it can be simplified, componentized, and delivered through more flexible technology infrastructure.

Data

The typical approach banks adopt for data is to recast historical data at least for a few dates, and to implement the new standards as quickly as possible to support collection on the new basis as a cross check. However, recasting historical data requires it to be rich and reliable — for instance on UTP triggers, forbearance or technical defaults.

Procedural changes over the years can also lead to significant difficulties in evaluating historical data according to the new criteria. While in some cases reasonable assumptions can be made to derive good enough proxies to support the development of scalars or recalibrated models, this is by no means a given.

Banks supervised by ECB have typically started or are about to start data collection. Banks that have not yet started might find that their systems require substantial updates before they can collect data and that necessary resources are already committed on work that cannot be easily re-prioritized.

Operational changes

Operationalization of the new DoD typically requires changes to existing systems and processes.

Examples of typical areas of operational challenge include:

- DPD counters are not systematically automated and operate on different definitions, and treatment of technical defaults doesn't have the necessary first line controls.
- UTP indicators can currently be defined broadly and allow a large degree of personal judgement. The new standards introduce stricter UTPs (e.g., specific definition of sale at a material loss) and will require stricter controls.
- Return to non-default status requires the implementation of new cure logic and controls against various tests for return to performing.

Business processes typically need to be changed to support better alignment and ownership throughout the default lifecycle, and associated data capture and audit trail.

Depending on existing processes and supporting technology, some banks will find that these changes can require significant time to implement and brand new solutions to be established, e.g., the introduction of new workflows.

Governance and documentation

The new standards, in line with trends over the recent years, require a much greater level of documentation of processes and procedures. As well as robust governance and audit trail, including a register of all current and historical default definitions used.

Many banks have found that this is substantially more than had currently been in place, and are considering the adoption of an end-to-end workflow process to provide both robust controls (including audit trail) and structured data collection. So banks should consider in their timeline the time it takes to build a clear picture of the current end-to-end process and associated roles and responsibilities in managing non-performing exposures throughout the lifecycle, and technology options to bring a common workflow and data capture around it.

Finally, the new standards add to the already extensive expectations regulators have of the audit function, who are expected to carry out a regular review of the bank's approach to the new standards.

Capital impact

From a capital planning standpoint, banks need to consider the potential size of impacts; these could be significant for specific portfolios, particularly for banks on Foundation IRB, and for portfolios that will move to F-IRB when the finalised Basel III reforms go live, as well as for banks with large gaps to the new DoD, such as having to shift from a 180 days past due standard to 90 days.

Based on a sample of impact assessments we have generally observed

an increase in PDs, mainly due to new materiality thresholds, which is offset by a decrease in LGDs from higher cure rates.

Impacts at individual portfolio level can also be much more material — it is not uncommon to observe RWA impacts in the order of -25% to +25% on individual portfolios.

The stricter requirements for returning defaulted exposures to non-default status is also likely to lead to an increase in default stocks in the medium term, with associated impacts on RWA and impairments.

Business practices

Business stakeholders have a key role in the program to review the impact of the new requirements on customers and/or financial performance, and make changes to business practices accordingly.

From an economic standpoint, the impacts on capital can vary greatly from bank to bank and across different portfolios. A material capital (and/or IFRS9 impairment) change may warrant a review of current processes that are designed to prevent and recover defaults, or pricing or lending criteria. This can particularly be the case in higher risk portfolios where cure criteria may lead to punitive capital charges having to be held longer than is currently the case. Another example would be the selling of credit obligations, which, if they trigger default, will be reflected in higher risk estimates than might currently be the case.

More generally, banks will need to consider how the new standards need to be reflected in the end to end ‘customer journeys’.

Timeline and implementation approach

The current end of 2020 timeline looks challenging for many banks. Updating internal systems and processes to be able to collect data on the new DoD basis and allow some parallel run prior to reporting ‘go-live’ is a priority. For banks that are looking to establish the foundation of a more sustainable data strategy (e.g., to support advanced analytics), this might require a phased implementation.

From a modelling standpoint, the volume of work is potentially vast. So close engagement with supervisors and regulators, and a structured approach based on a robust impact assessment and prioritizing redevelopment for most material and/or impacted portfolios is key.

What banks should do now

Banks are at different stages in their programs — in our experience, SIIs are mostly ahead of the curve, followed by IRB banks, ahead of SA banks. This follows naturally from the complexity of change and level of necessary supervisory involvement, but the fact is that the timetable looks challenging for all banks and the risk for technical debt and RWA inefficiencies after 2020 is significant.

Banks need to progress quickly with their DoD implementation efforts. Key steps include:

Program governance	Establish programme governance to provide coordination across policy decisions, approaches, external communication, and timing of implementation and reporting. Some banks may also require coordination across multiple entities and jurisdictions where systems and processes are shared.
Impact assessment	Assess impact on historical default data to inform policy decisions and approach to models updates. Broader IT and process impacts also need to be assessed in detail to allow sufficient lead time to make necessary changes and to start collecting data on the new basis as early as possible.
Policy decisions	Define internal policy and standards, including with regards to available discretions and jurisdictional discrepancies in the application of the new DoD. This is ideally informed by the impact assessment, and provides sufficient guidance for interpretation across models, business lines, and business processes to be consistent.
IT and process changes	Implement necessary changes to IT systems and processes, with a view to start collecting data as early as possible to support the model updates.
Models	Estimate scalars and establish a prioritized plan for model updates, including other regulatory changes happening ahead of 2021 (e.g., margin of conservatism), and for changes related to the broader model universe (e.g., IFRS9, stress testing etc.).
Regulatory applications	Banks will seek to prioritize model redevelopment and progressively move away from the application of scalars and this needs to be managed closely with the regulators and supervisors.
Parallel run and reporting	Most banks will be seeking to have a parallel run period for all impacted reporting, both internal and external.

Publications

Definition of default

Mar-19	**PRA** policy statement on the definition of default (PS7/19) *Note: includes materiality thresholds that deviate from those proposed by the EBA*
Nov-18	**ECB** regulation on the materiality of credit obligations past due ((EU) 2018/1845)
Jun-18	**ECB** guidance on the process for implementing new definition of default *Note: this was not published but submitted directly to SIIs in the SSM*
Dec-17	**EBA** opinion on the use of the 180 days past due criterion (EBA/Op/2017/17)
Oct-17	**EC** regulation on RTS for the materiality threshold for credit obligations past due ((EU) 2018/171)
Sep-16	**EBA** final draft RTS on the materiality threshold for credit obligations past due (EBA/RTS/2016/06)
Sep-16	**EBA** guidelines on the application of the definition of default (EBA/GL/2016/07)
Sep-16	**EBA** report on the results from DoD QIS
Mar-16	**ECB** regulation on the exercise of discretions ((EU) 2016/445) *Note: includes a requirement to use 90 DPD for all exposures, removing the option for 180 DPD*
Jun-15	**EC** regulation on insolvency proceedings ((EU) 2015/848) *Note: includes a set of arrangements to be considered similar to bankruptcy under new DoD*
Dec-13	**EC** regulation on RTS for calculating specific and general credit risk adjustments ((EU) 183/2014)
Jul-13	**EBA** final draft RTS on the calculation of specific and general credit risk adjustments (EBA/RTS/2013/04)

Broader regulatory reform

Dec-17	**BCBS** publication Basel III: Finalising post-crisis reforms
Apr-16	**BCBS** report Regulatory consistency assessment programme (RCAP) – Analysis of RWAs for credit risk in the banking book

Internal models

Jul-19	**EBA** progress report on IRB roadmap
Jul-19	**ECB** guide to internal models – Risk-type-specific topics chapter
Mar-19	**EBA** guidelines for the estimation of downturn LGD (EBA/GL/2019/03)
Feb-19	**EBA** guidelines on Credit Risk Mitigation for institutions applying the IRB approach with own estimates of LGDs (EBA/CP/2019/01)
Nov-18	**EBA** final draft RTS on specification of the nature, severity and duration of an economic downturn (EBA/RTS/2018/04)
Nov-18	**ECB** guide to internal models – General topics chapter
Mar-18	**EBA** report on CRM framework
Nov-17	**EBA** guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (EBA/GL/2017/16)
Feb-17	**ECB** guide for the targeted review of internal models (TRIM)
Jul-16	**EBA** final draft RTS on IRB and AMA assessment methodology (EBA/RTS/2016/03)
Jun-16	**EBA** final draft RTS on Risk Weights for specialised lending exposures (EBA/RTS/2016/02)
May-14	**EC** regulation (RTS) for assessing material changes of IRB and AMA approach ((EU) No 529/2014)

Non-performing and forborne exposures

Oct-18	**EBA** guidelines on management of non-performing and forborne exposures (EBA/GL/2018/06)
Apr-17	**BCBS** guidelines on the prudential treatment of problem assets – definitions of non-performing exposures and forbearance
Feb-15	**EC** regulation on ITS with regard to supervisory reporting ((EU) 2015/227)
Jul-14	**EBA** final draft ITS on supervisory reporting on forbearance and non-performing exposures (EBA/ITS/2013/03/rev1)

New DoD on a page

Default type	Indicator	Criteria
DPD (Days past due)	**90 DPD**	The following conditions are met for an overdue credit obligation: (1) Total amount overdue is > EUR *Y* **and** (2) Total amount overdue is > *X*% of total on-balance exposures **and** (3) Total amount overdue has met conditions (1) and (2) > for 90 consecutive days **and** (4) It is not a technical default where: Total amount overdue is the sum of all overdue principal, interest and fees related to the facility, the obligor (excluding any joint obligations) or the unique set of joint obligors, depending on the level of default application and credit arrangement Total on-balance exposure is the total on-balance exposure related to the facility, the obligor (excluding any joint obligations) or the unique set of joint obligors, depending on the level of default application and credit arrangement *Y* = 100 or different threshold < 100 per Competent Authority decision for retail exposures *Y* = 500 or different threshold < 500 per Competent Authority decision for corporate exposures *X* = 1 or different threshold ≤2.5 per Competent Authority decision
UTP (Unlikeliness to pay)	**Non-accrued status**	The credit obligation is put on non-accrued status (interest stops being recognised in the income statement due to decreased quality of the credit obligation)
	Specific Credit Risk Adjustment (SCRA)	(1) If the institution uses IFRS9: (1.1) The credit obligation is classified as Stage 3 **and** (1.2) The Stage 3 classification is not triggered by overdue repayment that does not meet the criteria of a 90 DPD default **or** (2) If the institution uses another accounting framework: (2.1) A SCRA has been made to the credit obligation **and** (2.2) The SCRA is not IBNR (incurred but not reported) **or** (3) If the institution uses IFRS9 and another accounting framework: it must then choose to consistently use either (1) or (2)
	Sale of the credit obligation	(1) The credit obligation is sold at an economic loss **and** (2) The sale is credit risk related **and** (3) *L* > *X*%, where *X* is a threshold ≤5% per decision by the institution where: $L = \frac{E - P}{E}$ *L* is the economic loss related with the sale of the credit obligation *E* is the total outstanding amount of the credit obligation subject to the sale, including interest and fees *P* is the price agreed for the sold credit obligation
	Distressed restructuring	(1) Concession have been extended to a debtor facing or about to face financial difficulties, resulting in a diminished financial obligation **and** (2) *DO* > *X*%, where *X* is a threshold ≤1% per decision by the institution where: Financial difficulties are specified in paragraphs 163-167 and 172-174 of Commission Implementing Regulation (EU) 2015/227 $DO = \frac{NPV_0 - NPV_1}{NPV_0}$ *DO* is the diminished financial obligation NPV_0 is the net present value of the obligation before concessions, discounted using the customer's original effective interest rate NPV_1 is the net present value of the obligation after concessions, discounted using the customer's original effective interest rate

<table>
<tr><th>Additional conditions</th><th>Default level and contagion</th><th>Minimum conditions for return to non-defaulted status</th></tr>
<tr>
<td>(1) DPD counting should be adjusted to the new payment schedule (if applicable) in any of these situations:
(1.1) Repayment is changed, postponed or suspended by the obligor in accordance with rights granted in the contract
(1.2) The obligor has changed due to merger or acquisition or similar transaction
(2) DPD counting should be suspended if:
(2.1) Repayment is suspended due law or legal restrictions
(3) DPD counting may be suspended if:
(3.1) Repayment is subject to formal dispute</td>
<td rowspan="3">Default should be applied at obligor level for all exposures except for retail exposures where default may be applied at facility level:
(1) For retail exposures where default applies at obligor level:
(1.1) When a credit obligation defaults, all other exposures of the obligor should also default, including those where the institution applies default at facility level
(1.2) When a joint credit obligation defaults, all other exposures of the same set of obligors and of each individual obligor should also default, (exceptions apply – see EBA guidelines)
(1.3) When a company defaults, all individuals that are fully liable for the company's liabilities should also default
(2) For retail exposures where default applies at facility level:
(2.1) When a credit obligation defaults other exposures of the obligor should not default unless:
(2.1.1) The institution has adopted a UTP in line with the 'pulling effect'
or
(2.1.2) The credit obligation has defaulted due to a UTP indicator that has been classified as reflective of the overall situation of the obligor</td>
<td rowspan="2">3 consecutive months during which no default conditions are met
This condition also applies to new exposures to the obligor, in particular if the defaulted exposures have been sold or written off</td>
</tr>
<tr>
<td rowspan="2">(1) UTP indications should be evaluated in the event of any of the following situations (in addition to events specified by the institution):
(1.1) Repayment has been changed, postponed or suspended by the obligor in accordance with rights granted in the contract
(1.2) Repayment has been suspended due to or legal restrictions
(1.3) Concessions have been extended that do not meet the conditions of a material distressed restructuring
(1.4) Purchase or origination of financial asset at a material discount
(1.5) One of the obligors of a joint obligation individually defaults
(1.6) When a company defaults; owners, partners and significant shareholders with limited liability should be evaluated
(2) Institutions should specify which UTP indicators reflect the overall situation of the obligor rather than that of the exposure, and should include (but is not limited to):
(2.1) Bankruptcy</td>
</tr>
<tr>
<td>(1) 12 consecutive months during which no default conditions are met, counting from the latest of:
(1.1) When concessions where extended
(1.2) When the default was recorded
(1.3) When any grace period in the restructured payment schedule ended
and
(2) During which a material payment (equivalent to what was previously past due or written off) has been made by the obligor
and
(3) During which payments have been made regularly according to the restructured payment schedule
and
(4) There are no past due credit obligations related to the restructured payment schedule
These conditions also apply to new exposures to the obligor, in particular if the defaulted exposures have been sold or written off</td>
</tr>
</table>

UTP (Unlikeliness to pay)	**Bankruptcy**	(1) The institution has filed for **or** (2) The obligor has sought (where this would avoid or delay repayment of the credit obligation) **or** (3) The obligor has been placed in (where this would avoid or delay repayment of the credit obligation) any of the following arrangements: (.1) Bankruptcy as recognised in applicable law **or** (.2) Any other arrangement listed in Annex A to Regulation (EU) 2015/848 **or** (.3) Any arrangement deemed similar to bankruptcy as specified by the institution based on applicable law and EBA guidelines
	Additional indications of unlikeliness to pay	The credit obligation meets criteria that the institution has defined for additional indications of unlikeliness to pay, which *should* or *may* directly trigger default, or trigger a case-by-case assessment of default (depending on indicator): (1) Such indicators *should* include: (1.1) The institution uses an accounting framework under which: (1.1.1) The credit obligation is recognised as impaired even if no SCRA has been assigned **and** (1.1.2) The impairment is not IBNR (incurred but not reported) (1.2) Credit fraud (1.3) Rules for contagion in the occurrence of default in a group of connected clients (1.4) In case of purchase or origination of a financial asset at a material discount: (1.4.1) Rules for assessing any deteriorated credit quality of the obligor (2) Such indicators *may* include (but are not limited to): (2.1) Same criteria as DPD default category but with institution defined thresholds that are lower than those defined by the CA (2.2) The obligor’s source of income to repay loan is no longer available (2.3) There are justified concerns about the obligor’s ability to generate stable and sufficient cash flows (2.4) The obligor’s leverage has increased significantly (2.5) Breach of the covenants of a credit contract (2.6) Collateral has been called by the institution (2.7) Default of a company fully owned by the obligor, where the obligor has provided a personal guarantee for that company’s obligations (2.8) ‘Pulling effect’ in line with the ITS with regard to supervisory reporting ((EU) 2015/227) with the same or different threshold (2.9) The obligation is reported as non-performing under Commission Implementing Regulation (EU) 680/2014 (2.10) Significant delays in payments to other creditors (2.11) A crisis in the sector of the obligor combined with a weak position of the obligor (2.12) Disappearance of an active market for an asset because of the financial difficulties of the obligor (2.13) In case concessions have been extended that do not meet the conditions of a material distressed restructuring: (2.13.1) Large lumpsum payment at the end of the repayment schedule (2.13.2) Significantly lower payments at the beginning of repayment schedule (2.13.3) Significant grace period at the beginning of the repayment schedule (2.13.4) The exposures to the obligor have been subject to distressed restructuring more than once

For an A2–version of New DoD on a page please download it from our website at www.ey.com/NewDefinitionOfDefault.

Notes:

1. *New DoD on a page is intended as a quick reference guide for the basic logic of the new definition and does not cover the entire regulatory scope; in particular, it does not cover requirements related to external data, default consistency and governance*
2. *All default indicators apply to all credit obligations toward the institution, the parent undertaking and its subsidiaries*

(1) UTP indications *should* be evaluated in the event of **any** of the following situations (in addition to events specified by the institution): (1.1) Repayment has been changed, postponed or suspended by the obligor in accordance with rights granted in the contract (1.2) Repayment has been suspended due to or legal restrictions (1.3) Concessions have been extended that do not meet the conditions of a material distressed restructuring (1.4) Purchase or origination of financial asset at a material discount (1.5) One of the obligors of a joint obligation individually defaults (1.6) When a company defaults; owners, partners and significant shareholders with limited liability should be evaluated (2) Institutions *should* specify which UTP indicators reflect the overall situation of the obligor rather than that of the exposure, and *should* include (but is not limited to): (2.1) Bankruptcy	Default *should* be applied at obligor level for all exposures except for retail exposures where default *may* be applied at facility level: (1) For retail exposures where default applies at obligor level: (1.1) When a credit obligation defaults, all other exposures of the obligor *should* also default, including those where the institution applies default at facility level (1.2) When a joint credit obligation defaults, all other exposures of the same set of obligors and of each individual obligor *should* also default, (exceptions apply – see EBA guidelines) (1.3) When a company defaults, all individuals that are fully liable for the company's liabilities *should* also default (2) For retail exposures where default applies at facility level: (2.1) When a credit obligation defaults other exposures of the obligor *should* not default unless: (2.1.1) The institution has adopted a UTP in line with the 'pulling effect' **or** (2.1.2) The credit obligation has defaulted due to a UTP indicator that has been classified as reflective of the overall situation of the obligor	3 consecutive months during which no default conditions are met This condition also applies to new exposures to the obligor, in particular if the defaulted exposures have been sold or written off

3. Special conditions apply to factoring arrangements and purchased receivables

4. Conditions related to the 180 days option have been excluded given that this option is being disallowed

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