Global Research
& Analytics

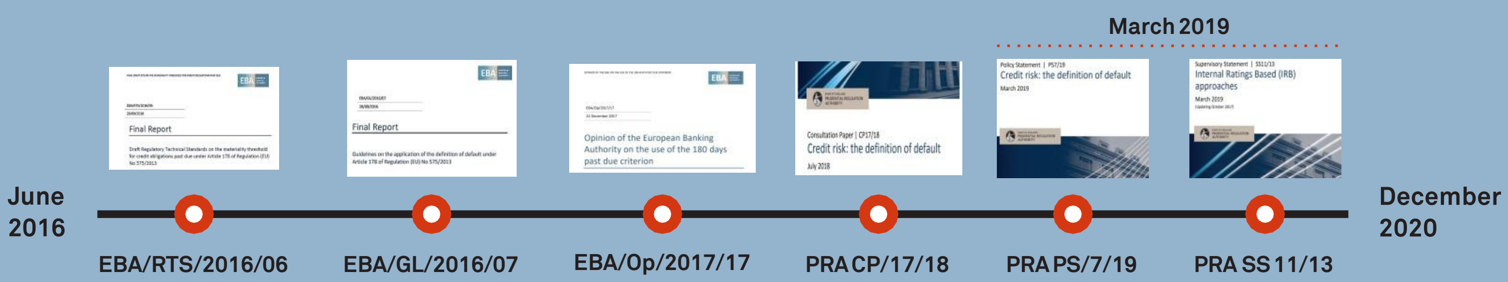
CRISIL
An S&P Global Company

Harmonizing default definition

On March 6, 2019, the Prudential Regulatory Authority (PRA) published its Policy Statement 7/19 on ‘Credit risk: definition of default’. The statement is applicable to UK banks, building societies and UK investment firms. The PRA’s final policy rules aim to harmonize the default definition to improve consistency and comparability as to how banks, building societies and UK investment firms apply regulatory requirement to their capital positions. The rules set out to harmonize the default definition for firms using standardized approach and internal ratings-based (IRB) approach. With the update in Policy Statement 7/19, the PRA has also published its revised supervisory statement on IRB approach, which has to be applied from December 31, 2020, unless a firm attains supervisory approval to extend this application date.

Background

The PRA and the European Banking Authority (EBA) have been working on the redevelopment of the IRB approach, and the new definition of default (DoD) is part of this broad initiative. Current PRA’s proposal is in line with the EBA rules, on that note here, we will identify similarities and differences in the PRA’s recent changes and compare them with EBA rules



Key updates on March 6, 2019

- An amendment to the credit risk part of the PRA rulebook to set thresholds for determining whether a credit obligation is material for the purpose of the Capital Requirements Regulation’s (575/2013) definition of default
- An update to the PRA’s expectations in ‘Supervisory Statement 11/13 IRB Approaches’ to implement the EBA’s regulatory products that relate to the definition of default

PRA’s and EBA’s recommendations on harmonizing default definition

Topics	EBA Rules (2016-17)	PRA (March 2019)
Materiality threshold	**Retail exposures:** • Absolute threshold range between €0 and €100 • Relative threshold range between 0% and 2.5% The EBA’s general recommendation is 1% for relative threshold. The final decision is of local authorities	**Retail exposures:** • 0% relative materiality threshold and a zero absolute threshold
	For non-retail exposures: • Absolute threshold range between €0 and €500 • Relative threshold range between 0% and 2.5% The EBA’s general recommendation is 1% for relative threshold. The final decision is of local authorities	**For non-retail exposures:** • 1% relative materiality threshold and a sterling equivalent of €500 absolute threshold • The PRA expects firms to use a lower materiality threshold than that set by the PRA (PRA Rulebook rule 6.1) as an indicator of unlikeliness to pay for non-retail exposure classes, if the lower threshold is a more relevant indication of default. When using a lower materiality threshold, firms should ensure compliance with paragraph 34 of the EBA Guidelines on the application of the definition of default (EBA/GL/2016/07)
Curesfrom Default Status	• A minimum probation period of three months (since non-triggering of default indicators) is established • For distressed restructuring, the probation period is one year	• The PRA expects firms to monitor this on an ongoing basis and to re-assess as and when appropriate
Days’past due (DPD)	**Counting of DPD** • Counting starts immediately after non-payment of any obligation (principal, interest, fees, etc) • DPD count is only suspended if there is a legal dispute or in case of particular leasing situations • Loan modifications and changes in obligors name (M&A) reset the clock • Technical past due situations are the only exception of non-application of the DPD threshold **180 DPD threshold** • 180 DPD can be applied for exposures to public sector entities (PSEs), consumer mortgages, and commercial real estate to SME • Specific (and stricter) conditions should be met for PSEs • However, the EBA considers that the 180 DPD special threshold should be removed (EBA/Op/2017/17).	• Firms should use 90 DPD for all exposure classes • Removing the use of 180 DPD with 90 DPD for all exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to PSEs

Topics	EBA Rules (2016-17)	PRA (March 2019)
Unlikeliness to pay	**Article 178 of Capital Requirements Regulation lists a total of six indicators of unlikeliness to pay. The new DoD elaborates them further, adds frauds as an additional indicator, and allows the institutions to set new ones** • Non-accrued status: Capital Requirements Regulation's previous criterion is preserved • Specific credit risk adjustments related to individual exposure • Sale of a credit obligation: – Sales motivated by credit deterioration are a default indicator – Criteria applies to all sales, even regular ones like securitization – Materiality threshold requirement: The sale should involve a loss greater than 5% to be a default indicator • Distressed Restructuring: – Represents an indicator of default if there is a material loss in net present value (NPV) as a result of restructuring – Maximum materiality threshold is 1% reduction in NPV • Bankruptcy: – Whether asked by lender or filed by debtor, bankruptcy remains a default indicator – Internal policies should clarify what is considered as bankruptcy status based on each exposure feature and applicable legislation in each geography • Other Indicators: Institutions can set other adequate indicators of unlikeliness to pay – External data can be used (e.g. delinquency with financial institutions) – Credit fraud detected before default is an anticipated indicator of default	• Firms should comply with EBA Guidelines for UTP indicators • Firms should comply with paragraphs 49 to 55, 72, 73, and 107 of EBA Guidelines on the application of the definition of default (EBA/GL/2016/07), which cover the treatment of distressed restructuring as an unlikeliness to pay criterion • The PRA expects the use of lower materiality thresholds as an indicator of unlikeliness to pay for non-retail exposure classes
DoD in retail – application at facility level	• Default in one facility (credit product) does not extend to the other exposures/facilities of the same obligor	• Firms should comply with EBA guidelines
DoD in retail – application at obligor level	• Default in one facility turns all the obligor exposures into default status	• Firms should comply with EBA guidelines

Reference:
EBA/RTS/2016/06, EBA/GL/2016/06, EBA/Op/2017/17, and https://www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-the-definition-of-default

For enquiries, please reach out to

Nageswara S Ganduri,
Director - R&A
+44-207-176-2558
Nageswara.Ganduri@crisil.com

Maninder Singh
Director – Business Development
+44-207-176-2556
Maninder.Singh@crisil.com

Shashi Sharma
Director - R&A
+44-207-176-2571
Shashi.Sharma@crisil.com

Kamlakant Tiwari
Lead Analyst
+44-207-176-2570
Kamlakant.Tiwari@crisil.com

Gautam Verma
Associate Director -
Business Development
+44-207-176-2555
Gautam.verma@crisil.com

Ritesh Kumar Agarwal
Director - Business
Development
+44-207-176-2552
Ritesh.agarwal@crisil.com

About CRISIL Limited
CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Global Research & Analytics
CRISIL Global Research & Analytics (GR&A) is the world's largest and top-ranked provider of high-end research, risk and analytics services. We are the world's largest provider of equity and fixed-income research support to banks and buy-side firms. We are also the foremost provider of end-to-end risk and analytics services that include quantitative support, front and middle office support, and regulatory and business process change management support to trading, risk management, regulatory and CFO functions at world's leading financial institutions. We also provide extensive support to banks in financial crime and compliance analytics. We are leaders in research support, and risk and analytics support, providing it to more than 75 global banks, 50 buy-side firms covering hedge funds, private equity, and asset management firms. Our research support enables coverage of over 3,300 stocks and 3,400 corporates and financial institutions globally. We support more than 15 bank holding companies in their regulatory requirements and submissions. We operate from 7 research centers in Argentina, China, India, and Poland, and across several time zones and languages.

Argentina | China | Hong Kong | **India** | Poland | Singapore | UK | USA | UAE
CRISIL Risk and Infrastructure Solutions Limited (A subsidiary of CRISIL Limited)
CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com
/company/crisil @CRISILLimited /CRISILLimited /user/CRISILLimited Follow us on @lifeatcrisil

CRISIL
An S&P Global Company