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Definition of default

What does the PRA's CP17/18 mean to you?

October 2018

Contents

Overview

Background

Following the financial crisis, the EBA has been actively engaged in developing a regulatory **'IRB roadmap'** with the aim of reducing the RWA variability across institutions using IRB models.

As part of this, the EBA has published 3 papers relating to the definition of default (DoD):

i. Regulatory Technical Standards (RTS) for the materiality threshold for credit obligations past due;

ii. Guidelines (GL) on the application of DoD; and

iii. EBA Opinion on the use of 180 days past due (DPD).

Before the PRA updates its Supervisory Statement (SS11/13 'internal ratings based (IRB) approaches') and PRA Handbook to formally implement the new EBA regulatory papers, the PRA published a Consultation Paper (CP) on 27th July 2018 (CP17/18 'credit risk: the definition of default') outlining its approach to implementing the above 3 items for PRA regulated firms.

The PRA's proposal for the first 2 items (GL and RTS) are applicable for firms using the standardised approach (SA) and IRB approach whereas the third item relates only to firms using the IRB approach.

Summary of the changes

In this latest CP, the PRA proposes the following:

Materiality thresholds	▪ Retail – set a 0% relative materiality threshold and zero absolute materiality threshold; ▪ Non-retail – set a 1% relative materiality threshold and a sterling equivalent of €500 absolute materiality threshold.
Use of 180 DPD criteria as DoD	▪ Remove the discretion to use 180 DPD instead of 90 DPD in the 'days past due' component of the DoD for exposures secured by residential or SME commercial real estate in the retail exposure class and/or exposures to public sector entities.
Application of the DoD	▪ Introduce an expectation that firms comply with the EBA's GL on the application of the DoD when applying the CRR DoD under Article 178.

Implementation roadmap

It is expected that the implementation of these CP requirements may require significant efforts and resources for some firms. In particular for IRB firms where their DoD will significantly change across rating systems. Some of the key areas impacted are:

Model recalibrations

PD, LGD and EAD models will need to be recalibrated or redeveloped (e.g. where 180 DPD used) to meet revised DoD

Data

Considerable effort may be needed to gather, source, and re-cast historical data. Challenges also around extending historical forbearance and recovery information for new default cases.

Lack of comprehensive reference data sets for LGD will result in MoCs.

A further challenge surrounds the use of bureau or external data and ensuring consistency in DoD.

Governance

Policies and procedures will need to be updated to reflect CP requirements. Appropriate application of Margins of Conservatism is required where historical default data cannot be re-casted or where there are other data, system or modelling limitations.

Processes

Processes to implement materiality thresholds relating to DPD, distressed debt restructuring and sale of credit obligations are key.

Systems

System flows will need to be updated to ensure revised DoD is appropriately flagged.

Objective of this paper

This paper will highlight the key implications of the requirements as proposed under the new PRA CP. The aim is to help firms understand the key impact and areas of consideration, to facilitate preparation for compliance with the expected regulatory requirements.

Key thematic messages

- EBA is completing its roadmap to reduce RWA variability.
- PRA is in process of generating CPs prior to consolidating expectations within SS11/13 and the PRA Handbook.
- DoD impacts most areas of standardised and IRB approaches, and the scale of the changes will vary significantly between firms.
- Firms should perform gap assessments against the new CP proposals and develop appropriate implementation plans.
- When firms consider their DoD implementation plans, firms should take a holistic view when designing solutions as this paper represents only one of several regulatory changes that are in the pipeline.
- Final DoD requirements will go-live on 1st Jan 2021.
- IRB firms will need to pre notify the PRA in good time to gain approval of rating system changes prior to go-live.

The consultation process for CP17/18 is open until 29th October 2018.

The proposed implementation go-live of all the items within this CP is 1st January 2021. This in line with the wider regulatory papers that form part of the EBA roadmap.

Firms should be aware that these timelines are inclusive of time needed for PRA approval so should ensure this is factored into implementation plans.

What does this mean for you?

This PRA CP is far reaching and will impact retail, non-retail, standardised and IRB firms to different extents. A summary of the key requirements and page numbers for more detail is provided below.

Summary of requirements and implementation of default definition

Requirements are based on CRR Article 178. A significant implementation period is provided for all firms. IRB firms will need PRA permission by 1st January 2021 to implement changes in their existing IRB rating systems.

Date of application: 1st January 2021

- Significant implementation period for IRB banks.
- Standardised banks also impacted.
- Introduced changes to be verified by Internal validation and classified according to Commission Delegated Regulation No 529/2014.
- Permission from PRA should be obtained by 1st January 2021.
- Final deadline for submitting application to be agreed with PRA.

Big picture 'take-aways'

The changes proposed in this CP are fundamental in nature and will have impacts across the end to end credit process.

As the default definition is the independent variable across all IRB models, the proposed changes will need to be considered holistically before implementing any of the other IRB changes on the regulatory horizon.

Global firms will need to consider local regulatory needs when designing solutions to ensure full compliance. In particular around application of thresholds and use of 180 DPD where requirements may vary.

Firms with certain portfolios under permanent partial use may potentially end up with inconsistent definitions of default.

A closer look–key requirements on the application of CRR Article 178 on the definition of default

Past due criterion p4&5

- Counting of DPD including materiality thresholds.
- Sum of all amounts past due on a group basis on a daily basis.
- Removal of 180 DPD threshold.

Indications of unlikeness to pay (UTP) p7

- Specific credit risk adjustments.
- Sale of credit obligations.
- Distressed restructuring.
- Other Indications of unlikeness to pay.

External data p6

- Alignment of the internal vs. external default definition.
- Quantify and apply margin of conservatism (MoC).

Consistency in application p7

- Ensure the default of a single obligor is identified across all exposures.
- Default across types of exposures.

Return to a non-default status p6

- Minimum conditions for a reclassification to a non-defaulted status to be defined in policy.
- Review and update policy and monitoring of the policy effectiveness.

Retail exposures p7

- Level of application.
- Facility level, including implementing a pulling effect criterion.
- Obligor level, with relevance to the treatment of joint exposures.

Documentation, internal policies, risk management p8

- Timeliness of the identification of default.
- Document default definition policies.
- Internal governance (approval, validation and review).

What does this mean for you?

Firms should consider the areas below when addressing the key components of the DoD framework to ensure compliance and best practice.

	Summary of requirements	Key challenges/considerations
Past due criterion: materiality thresholds for Retail exposures Defines the materiality thresholds to be applied by UK firms for Retail exposures.	• Apply a 0% relative and zero absolute materiality threshold for retail exposures that use a 'months in arrears' (MIA) approach. • It is unclear whether the non-zero thresholds will apply to non-MIA based payment allocation firms. • The PRA has conducted cost-benefit analysis of using different materiality thresholds with different payment schemes and concluded that there is no prudential benefit in changing the MIA approach but would add huge implementation burden. *A fundamental note is the definition of 'retail'. While the EBA GL aligns it with the definition of 'regulatory retail', this definition is subject to change from 2022 and will likely impact 'portfolio landlords'.*	• The biggest consideration is that continuing with an MIA approach, whilst pragmatic, is neither consistent with the DoD under CRR nor is it consistent with Stage 3 classification for IFRS 9 purposes. • It is unclear what cash flows should be considered when setting the threshold. This may result in accounts remaining MIA 1+ for long periods and will be difficult to align with cure definitions. • Where MIA approach is used, firms will need to identify and assess the materiality thresholds applied for the existing IRB models compared to the proposed ones. • For non-MIA approaches, firms need to decide on whether to adopt the proposed materiality thresholds as-is or to lower them. This will be a challenge as firms will need to analyse the impact of new thresholds to the existing ones and have supporting analysis to justify threshold.
Past due criterion: materiality thresholds for Non-retail exposures Defines the materiality thresholds to be applied by UK firms for Non-retail exposures.	• Apply a 1% relative and **€500 as the** absolute materiality threshold for non-retail exposures. • The PRA has also proposed to include an expectation in SS11/13 that firms can use lower materiality thresholds given that they demonstrate that it does not lead to high cure rate and does not lead to decrease in RWA and consequent capital requirements. *UK firms will need to bear in mind the potential for misalignment of regulatory thresholds across jurisdictions.* *A further point to note is the alignment of these thresholds with NPV losses for restructured/forborne accounts. Where the 1% threshold is applied to such accounts to determine whether (or not) these are in default, without applying the same to non-restructured accounts will introduce inconsistencies.*	• The PRA's expectation is that it is unlikely to lead to any material change in number of defaults as the non-retail exposures defaults is mainly driven by UTP (e.g. watch-list) triggers. • Firms need to decide on whether to adopt the proposed materiality thresholds as-is or to lower them. This poses a challenge as analyse is needed to determine the impact of new thresholds. • If the decision is to rebut the proposed thresholds then firms will need to define and assess whether to use one threshold for the whole non-retail book or a different one based on the portfolio. • Consideration of cross-default is expected for non-retail portfolios. As such there is a question around whether this will contaminate the 'relative threshold'. • Firms have struggled to implement these changes due to data and IT impacts. Firms are performing gap assessments to shape implementation programmes.

What does this mean for you?

	Summary of requirements	Key challenges/considerations
Past due criterion: use of 180 DPD criteria as DoD The application of 180 DPD will be removed. This is likely to pose a challenge for larger firms with varying DPD measures.	• The CP proposes to remove the discretion to allow usage of 180 DPD as DoD trigger under CRR Article 178. • It will be aligned with the 90 DPD, which will further reduce the unwarranted variance in RWA and facilitate comparable parameters with entities within UK and between UK and EEA. *Tier 1 UK firms are already running large programmes to re-develop models as a consequence of this change from 180 to 90 DPD.*	• Firms are struggling to understand the full impact of this change. PD is expected to increase (due to increased number of defaults) and LGD is expected to decrease (mainly due to cure rates) but the counter-balance between these two is not understood. • Firms will need to consider LGD floors when understanding the 90 DPD requirement. Portfolio LGD decrease is currently constrained to 10%/15% on retail and commercial exposures secured by immovable property. But Basel III reforms will further constrain the impact owing to revised floors. • DoD alignment across regulatory and accounting frameworks should be considered (e.g. IFRS 9) to ensure that wider Use Test requirements are met. • Firms will need to assess the system/IT capability to identify the 90 DPD for such portfolios accurately on historical data. Proxies and MoCs may need to be applied.
Past due criterion: application of the past due criterion Firms will need to consider the counting of DPD, sum of all amounts past due on a group wide basis and a daily measurement, and avoidance of technical default (such as data or system error of the bank).	• Firms will need to consider: - the counting of DPD (including special considerations such as credit arrangements); - sum of all amounts past due on a group wide basis and a daily measurement; and - avoidance of technical default (such as data or system error of the bank). *Consideration of cross-default is expected for non-retail portfolios. As such there is a question around whether this will contaminate the 'relative threshold'.*	• A key struggle for firms is to ensure that credit arrangements that allow the client to change the schedule, suspend or postpone the payments under certain conditions, are not considered past due. • For non-retail exposures, a challenge will be to ensure that DPD can be calculated on a daily basis to allow comparison with the materiality threshold. • A further operational challenge will be for firms to ensure that all exposures of an obligor can be identified, and amounts past due can be aggregated and compared with thresholds. • Firms are struggling to evaluate the treatment/calculation of DPD at the time of merger or acquisition and are developing policy to define consistent application of approach. • Firms will need to consider prior PRA approval before changes can be formally applied to IRB models.

What does this mean for you?

	Summary of requirements	Key challenges/considerations
Use of external data Applicable to firms that use external data to supplement internal data for IRB purposes. Extends alignment of internal and external DoD, quality of associated documentation, analysing differences and applying MoC where required.	• External data used for the purpose of parameter estimation needs to be representative of the portfolio including the alignment with the internal DoD of the firm. • Assess differences between the internal and external data, definitions, and assess the materiality on the risk parameters. • Adjust estimates for identified material differences, or MoC where this is not feasible. *Where firms use external data, in the absence of a 'default flag' within this external source, meeting these requirements will prove all the more challenging.*	• Identifying/mapping all the areas where external data is utilised for IRB parameter estimation and capital calculations will be a key challenge. • Firms are struggling to demonstrate that the external data used is representative of the portfolio. Firms are using some key metrics that exists in both internal and external data to help with this. • Alignment of DoD between internal and external data should be demonstrated, to ensure that differences are understood and quantified. • The quantification of these differences will be a challenge and firms are documenting their approaches typically as part of their Margin of Conservatism Policy to promote consistency.
Return to a non-default status Section covers the requirements around transition from the default account/obligor status to non-default. Extends conditions to reclassify to a non-default status and monitoring of the effectiveness of the policy.	• Identify triggers that apply to maintain exposure in default. • Estimation of cure rates and probation period for each portfolio and each default type with special consideration to distressed restructured products should be performed. • Estimation of re-default rates with special consideration for distressed restructured products should be performed. • DoD policies should define probation period approach and estimation approaches to ensure consistent application.	• Firms are finding this area to be operationally challenging because a minimum probation period needs to be defined before an exposure/obligor can be reclassified from default to non-default status. • Implementing the probation period may be challenging as firms need to ensure that a minimum 3 months probation period applies, and for 'distressed restructured' exposures, probation periods of at least 1 year should be enforced. • Firms are performing extensive cure rate/probation period analysis to support probation period set. Firms will need to perform this analysis on an ongoing basis to support probation period. • Firms need to give consideration to applying and defining policies and procedures for returning to non-default. This is to help align triggers across risk management practices (such as risk appetite) and other regulatory requirements (such as ECB guidance to firms on NPL and IFRS 9).

What does this mean for you?

	Summary of requirements	Key challenges/considerations
Indications of unlikeliness to pay (UTP) Important UTP clarifications provided across non-accrued status, specific credit risk adjustments (SCRA), sale of credit obligations, distressed restructuring, bankruptcy, other UTP indicators and governance process.	• When selling credit obligations at a loss, the EBA GL requires firms to analyse reasons for the sale and quantify the economic loss with losses above 5% deemed in default. • The EBA GL better defines a **'distressed restructured credit'** and requires diminished financial obligations above 1% to be deemed in default. • All Stage 3 IFRS 9 expected credit loss (ECL) should be considered SCRA and in default. *The treatment of SCRAs on UTP is not clearly articulated and is a key challenge, especially given recent regulatory communication around classification of IFRS 9 impairments.*	• Data is deemed the biggest challenge specifically for distressed restructuring. Some known data issues are: inconsistent/incomplete forbearance data captured historically, no linkage between original and new accounts (forborne), system inability to capture other UTPs. Firms are identifying proxies in systems to bridge these issues and apply MoC as an interim measure. • Firms should consider reviewing their existing UTP criteria and performing gap analysis to assess whether it is aligned with requirements such as SCRA, non-accrued status and sale of credit obligations (with the attached materiality of 5%). • This requirement is likely to pose a significant challenge to firms as they will be expected to perform robust analysis to defend UTP thresholds on an ongoing basis, and report and monitor thresholds. Implementing these thresholds is also likely to impact systems and reporting regimes.
Consistency of application and retail exposures Focus on the consistent application across retail exposures. Extends default of a single obligor, consistent definition across products, alignment of DoD with the risk management practices, 'pulling effect' and governance process.	• Ensure that the default of a single obligor is fully identified across all exposures in all legal entities and geographical areas. • Consistent DoD to be applied for a single exposure/product type. • DoD in the retail book should reflect the internal risk management practices of the firm. • Evaluate the DPD treatment for joint exposures, where applicable, where more than one obligor is responsible for the payment.	• The overarching challenges will be to reconstruct historical default definition, model implications and enhancements of systems to implement approach. • Where a firm is a parent institution, the key challenge is to ensure the same DoD applied to a single type of exposure across the whole group. • Firms must ensure that the DoD is applied consistently at the level of an individual credit facility or obligor – level of application should be driven by internal risk management practices. • Where DoD is applied at facility level, a challenge will be to incorporate the **'pulling effect'.** Firms are looking to achieve this by identifying the list of indicators which reflects the condition of the obligor instead of the status at a single exposure type. • Where DoD is applied at the obligor level, a challenge will be to clearly define the treatment of joint exposures including triggers for default.

What does this mean for you?

Documentation, internal policies, risk management

Enforces the importance of the governance process on DoD to ensure IRB parameters are estimated as per the regulatory expectations. Extends identification of default, DoD policies and internal governance.

Summary of requirements

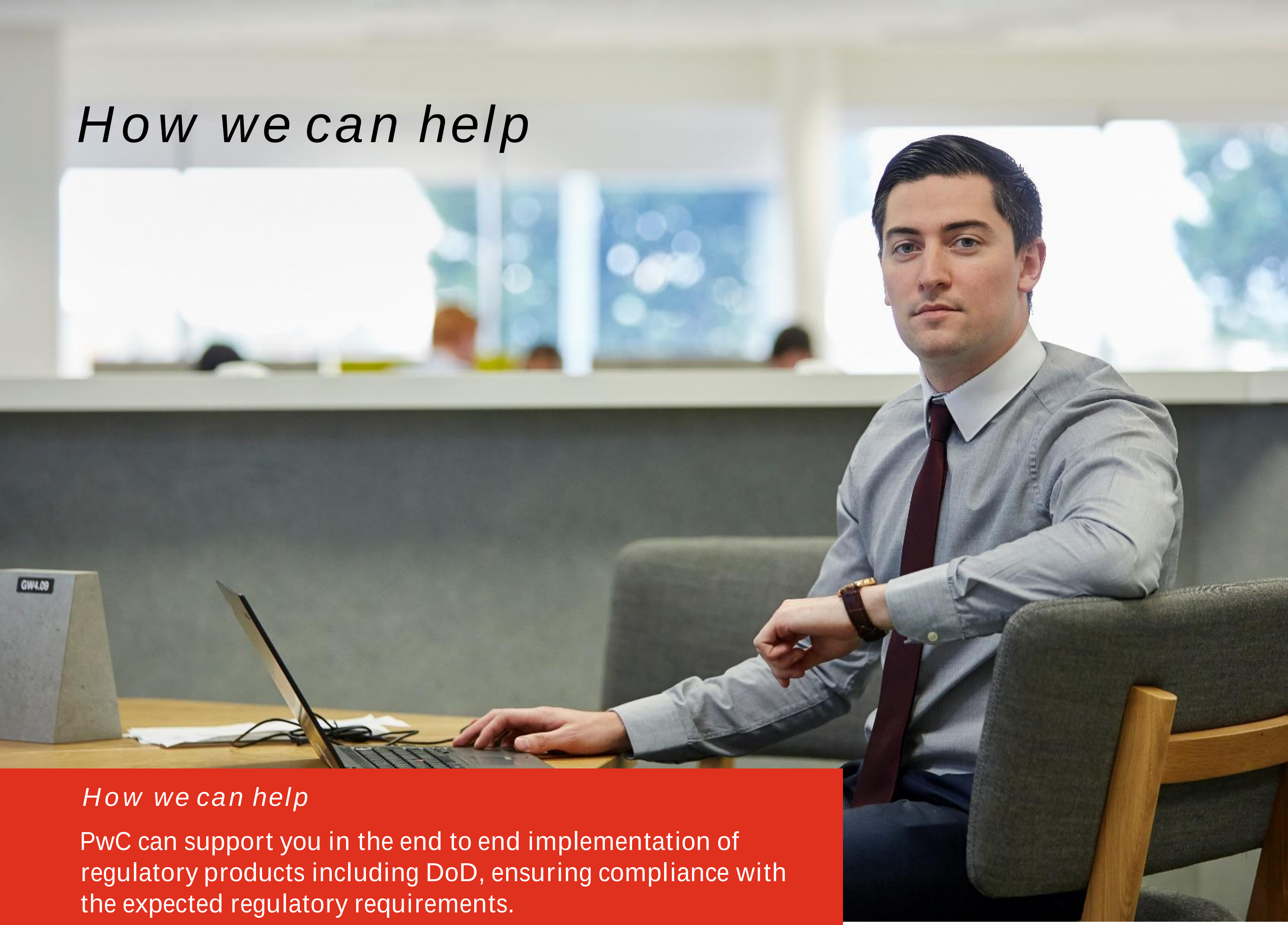
- Firms should have DoD policies in place and in particular have procedures on the application of the criteria for UTPs, criteria for reclassification to a non-defaulted status, and maintain an updated register of all default definitions of default.
- Firms should have effective processes to allow them to obtain relevant information in order to identify defaults in a timely manner, and where possible, in an automatic manner.
- Controls should be in place to ensure relevant information is used in the default identification process and marked in all relevant IT systems as such.
- IRB firms must ensure DoD policies are approved by the management body and is used consistently for own funds calculation. Internal Audit will be expected to regularly review the robustness of the DoD process.

UTP policies should clearly define between 'hard' and 'soft' triggers to ensure consistent application.

Key challenges/considerations

- A key challenge for firms is to review and update governance processes to promote consistent and effective application of the DoD at a firm level.
- Firms should consider developing comprehensive DoD policies and procedures to ensure all CP requirements are met with appropriate analysis/rationale to justify any assumptions made.
- Firms should consider updating internal policies and procedures to capture other additional indications of UTP including treatment of cross-defaults and utilising external databases.
- Firms should consider good quality implementation of default identification because these processes will be subject to regular audit review.
- A further challenge firms are facing is to ensure that their DoD is aligned across wider regulatory requirements and other risk management processes (e.g. risk appetite and IFRS 9).

How we can help



How we can help

PwC can support you in the end to end implementation of regulatory products including DoD, ensuring compliance with the expected regulatory requirements.

Perform a detailed gap assessment of your DoD framework (covering data, policies, models and systems), and design a roadmap for enhancements to comply with the updated DoD regulations.

Develop a remediation/implementation plan with a cost/benefit business case to support and better-inform key stakeholders.

Design, define, develop and enhance existing governance processes (including policies and procedures) to comply with the new regulations including alignment across business lines and risk management practices.

Validate/review of updated policies and model adjustments including the CRR checklist assessment to verify compliance with the regulations.

Design and perform model re-calibrations/ re-development in accordance with the regulatory products (such as DoD, PD/LGD specific and downturn adjustments).

Conduct quantitative and qualitative impact studies to evaluate the impact of new DoD, including the choice of materiality thresholds, on risk parameters and RWA.

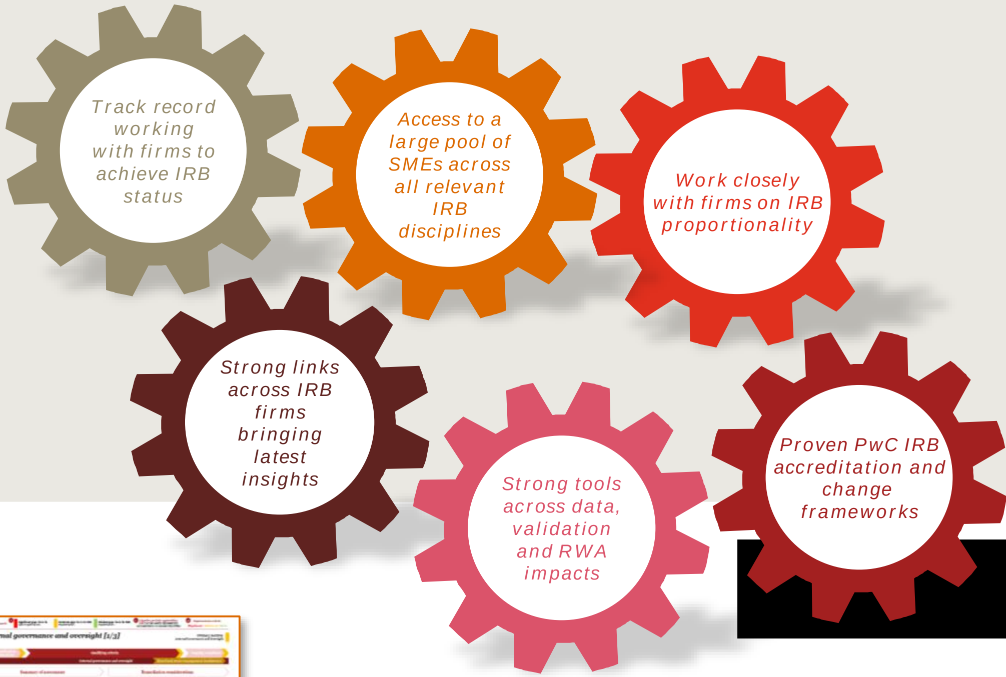
Produce/review the PRA IRB change approval application and engage with senior stakeholders within the firm and PRA throughout the programme.

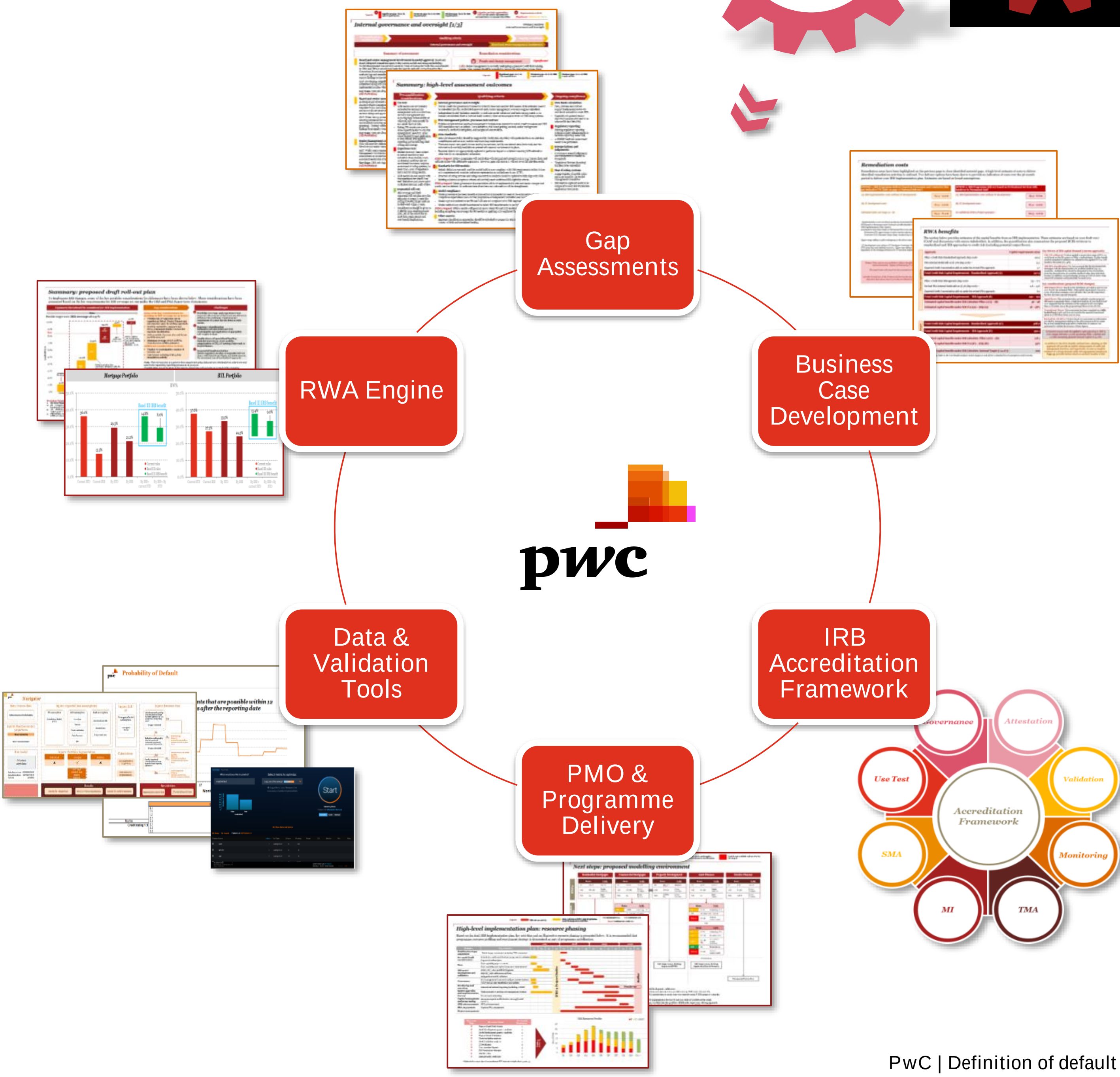
Define and develop/update model monitoring framework and external reporting processes and governance (Pillar 3 and COREP).

Our enablers and tools to support you

How we can help – enablers and tools

PwC has developed a suite of enablers and tools that can be used to support you in the end to end implementation of regulatory products including DoD, ensuring compliance with the expected regulatory requirements.





Key regulatory horizon – are you ready?

The financial services sector is in a period of regulatory change. Firms need to be aware of key existing live requirements but also on pipeline requirements to ensure compliance and best practice.

Finalised requirements

PRA regulated firms must comply with a varied regulatory landscape. This will cover PRA requirements as well as wider EBA regulatory technical standards, implementation technical standards, and guidelines.

PRA	Updated in Oct 17	Supervisory Statement of IRB Approaches (SS11/13)
PRA	Updated in Apr 17	Credit risk mitigation (SS17/13)
EBA	Live in Jan 21	GL on the application of the definition of default (EBA/GL/2016/07)
EBA	Live in Jan 21	GL on estimation of PD, LGD and treatment of defaulted exposures (EBA/GL/2017/16)
EBA	Live in Oct 17	RTS on materiality threshold of credit obligation past due (EBA RTS 2018/171)
EBA	Live in Jul 16	RTS on IRB Assessment Methodology (EBA/RTS/2016/03)
EBA	Live in Jul 14	ITS on supervisory reporting on forbearance and non-performing exposures (EBA/ITS/2013/03/rev1)
EBA	Live in Feb 14	RTS on specification of the calculation of specific and general credit risk adjustments (EBA/RTS/183/2014)
EBA	Live in Jun 16	Final draft RTS on Assigning Risk Weights to Specialised Lending Exposures (EBA/RTS/2016/02)
ECB	Live in Jun 18	Implementation of the new Definition of Default: Process guidance for significant institutions using the IRB approach
ECB	Live in Feb 17	Targeted review of internal models (TRIM)
BCBS	Live in Jan 22	Basel III: Finalising post-crisis reforms
BCBS	Live in Apr 17	Guidelines: Prudential treatment of problem assets: definitions of non-performing exposures and forbearance
BCBS	Live in Apr 16	Regulatory consistency assessment programme (RCAP): Analysis of RWAs for credit risk in the banking book

Requirements in consultation

PRA regulated firms should aim to have strong regulatory horizon scanning mechanisms to ensure the full regulatory landscape is understood and impact defined. The focus of this paper is highlighted in green below.

PRA	Closes on 28 Oct Live in Jan 21	Credit risk: the definition of default (CP 17/18)
EBA	Live in Jan 21	CP on RTS on the specification of the nature, severity and duration of an economic downturn (CP/EBA/2017/02)
EBA	Live in Jan 21	CP on GL for the estimation of LGD appropriate for an economic downturn (EBA/CP/2018/08)
EBA	Live in Jan 20	CP on GL on disclosure of non-performing and forborne exposures (EBA/CP/2018/06)
EBA	Live in Jan 19	CP on Guidelines on management of non-performing and forborne exposures (EBA/CP/2018/01)
ECB	Not applicable	Working Paper: Proposal on ELBE and LGD in-default: tackling capital requirements after the financial crisis (WP 2165)
ECB	Live in Jan 21	ECB regulation on the definition of materiality threshold for credit obligations past due

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