

**REGULATORY MONITORING
HARWELL**

**NEW DEFINITION OF
REGULATORY DEFAULT**

New regulatory definition of Default

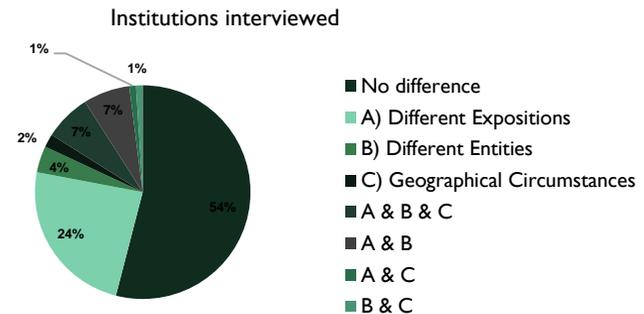
Background:

- Disparity in the implementation of the definition of non-payment in the application of the Basel III Standard in Europe (Article 178 of Regulation (EU) No. 575/2013).
- Incomparability between the synthetic credit risk measures of banking institutions.
- Impacts on the main credit risk measures (Probability of Default, Loss Given Default, Default Exposure) and ultimately on the required regulatory capital.

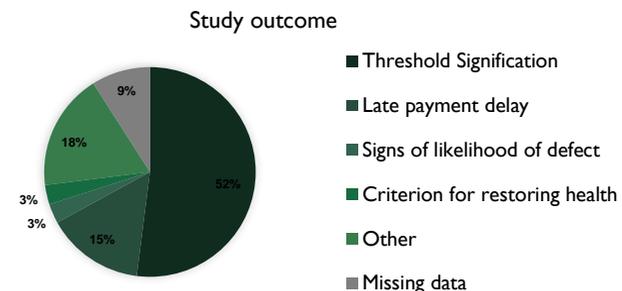
Goal:

- Harmonisation deemed necessary by the European Banking Authority to reduce heterogeneity and increase comparability between European banking institutions.

European Banking Authority Study, disparity within the same banking group: presence of different default definitions



European Banking Authority Study, reasons for disparity



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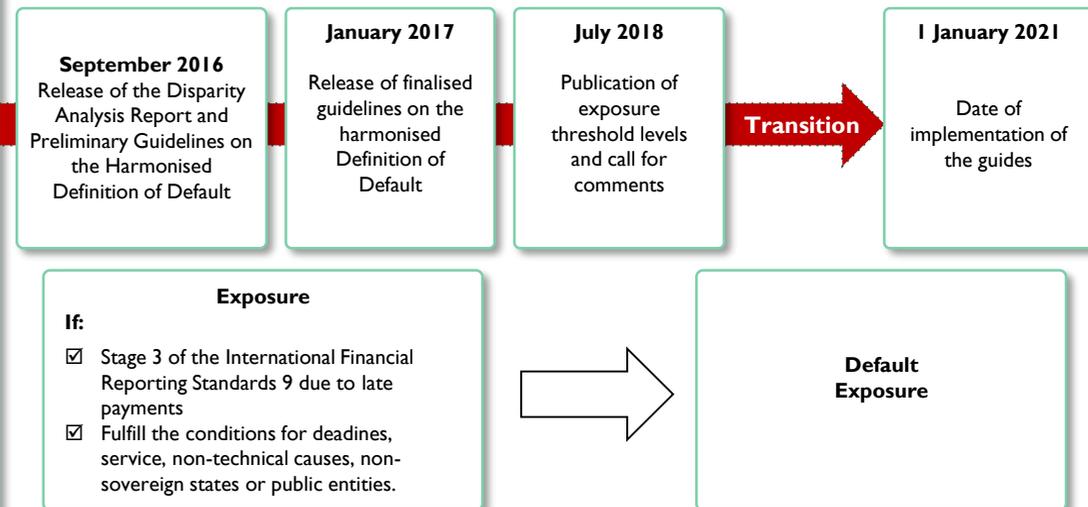
Application scope:

- Bank approach of Internal Rating (IN) or standard approach (the Standard Approach's maximum payment term remains at 90 days).

Conducted along with accounting standards:

- (EU) Regulation No. 575/2013 remains predominant compared to IFRS 9.
- The classification under Stage/Step 2 of IFRS 9 should not be mistaken for an indicator of default.
- Exposures impaired only in accounting terms are not considered to be in default. (Art. 38 of the "Guidelines on the Application of the Definition of Default under Article 178 of (EU) Regulation No. 575/2013")
- The classification in Stage/Step 3 according to IFRS 9 may be an indicator of default, and should be associated with the provisions adopted for late payment; exposures to sovereign states and public entities; technical failure to pay; significant exposure threshold. If these conditions are met then the exposures in Stage 3 according to International Financial Reporting Standards 9 are considered to be in default.

Time table for the Harmonisation of Article 178 of (EU) Regulation No. 575/2013:



Default indicators

New regulatory definition of Default

| | All exposure | | |
|------------------------------------|---|---|---|
| | Purchased receivables | Retail receivables | Sovereign States, Municipalities, Public Entities |
| Payment period | <ul style="list-style-type: none"> • 180 days maximum, excluding bonds. (European Central Bank project: 90 days) • Adjustment of the late payment count to the new payment schedule (if applicable). • Interruption of the late payment count in case of a legal provision interrupting the payment. • Suspension of the late payment count in case of litigation having been filed. • Deadline exclusion due to technical problems. Eligible technical causes are listed. | | |
| | Introduction of specific conditions which determine how overdue days are counted. | Conditions regarding the 2 exclusive options to determine account default: facility level or debtor level. Spillover conditions for collective loans. Spillover conditions between credit facilities. | Possibility of a specific discretionary treatment. 180 days maximum, excluding requirements |
| Indicator of likelihood of default | More precise definition: Adjustments to outstanding debts due to the deterioration of the creditworthiness of debtors; economic losses on the sale of receivables; threshold for the service of losses (planned: €100 for default exposure, € 500 for another exposure, or 1% of the debtor's total outstanding debt); conditions for identifying default following a reorganisation of the debts; bankruptcy of the debtor. Introduction of additional default indicators. | | Nothing other than late payment |
| Default based on external data | Detailed requirement of the handling of default indicators contained in external sources. | | |
| Consistency requirements | The scope of the definition of default must be <u>rigorous and consistent</u> throughout the banking group for the same types of exposure. Compulsory inclusion of this new default definition in estimating credit risk parameters. | | |

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The exit conditions of the fault state :

- Default conditions avoided for at least 3 consecutive months.
- Considerations regarding the debtor's behavior and financial health in the solvency assessment.
- If the bank considers that the debtor is still fragile despite the resumption of payments, it must remain in default.
- New exposures related to a debtor who has been reinstated (even if the old debts have been removed from the balance sheet) must be assessed with the mentioned historical criteria.
- For debtors with restructured debt, the observation period for a debtor's non-breach of the solvency conditions must be of at least 1 year.
- Debtor restructuring (merger, acquisition), with no designation changes, can change the observation periods.

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European Banking Authority recommendations

1. Revision (reprocessing) of historical data in accordance with these new definitions, in particular with the significant exposure levels.
 - Obligation to request approval of the new default definition, for banks with Internal Rating.
2. Evaluate and report the magnitude of the impact on risk parameters and capital requirements (compared to the old default definition)
 1. Inclusion of conservatism margins in credit ratings to capture (residual) distortions arising from the variety of default definitions in past data.
 - Conservatism margins should be evaluated regularly throughout the observation periods, and adjusted to reflect the new definition of default, as well as identifying defaults in a uniform manner.

Impacts

- *Probability of historical defaults* to be analysed again after adjustment, taking into account the new default criteria:
 - Potentially drastic changes in Default Probability and scoring grids.
- *Loss Given Default*. Impact: *low and a priori*. *The losses and recovery costs should not be strongly influenced by the new measures.*
- *Exposure At Default*. Significant impacts for institutions that:
 - Did not freeze the late payment count in cases of loan restructuring (change of periods and amounts...)
 - Did not take into account delays with a technical origin.
 - Did not have a uniform significant exposure threshold.
- Process of reporting the information necessary for the rapid detection of defaults to relevant persons:
 - Collect daily default indicators when automated processes are available, and optimize the frequency of reviews when this is not the case.
 - Effective classification of exposures to default based on updated indicators and valuations.
 - Establish control mechanisms (relevance, completeness, responsiveness) of previous processes.

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