

EBA/CP/2014/32

31 October 2014

Consultation Paper

Draft Regulatory Technical Standards on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013

Contents

1. Responding to this Consultation	3
2. Executive Summary	4
3. Background and rationale	6
4. Draft regulatory TS on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013	10
5. Accompanying documents	17
5.1 Impact Assessment on the RTS on the materiality threshold for past due exposures	17
1. Introduction	17
2. Problem definition	17
3. Objectives	18
4. Baseline scenario	19
5. Assessment of the technical options	23
6. Impacts of the technical options	27
6.2 Overview of questions for Consultation	32

1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 31.01.2015. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

Article 178 of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR) specifies the definition of default that is used for the purpose of IRB Approach according to Chapter 3 of Title II in Part three of the CRR as well as for the Standardised Approach in line with Article 127 of the CRR. The definition specifies among others that a default shall be considered to have occurred when the obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries. The materiality threshold of such obligations past due is set by the competent authority and reflects a level of risk that the competent authority considers to be reasonable.

In this regard, Article 178(6) of the CRR mandates the EBA to specify the conditions according to which a competent authority shall set the threshold. These draft RTS consequently specify the conditions according to which a competent authority shall set the materiality threshold. This will help ensure consistency in the setting of the materiality threshold across the entire EU.

Due to the wide range of practices used currently by the institutions with regard to the materiality thresholds, in part as a consequence of different requirements in this regard set by national competent authorities, these RTS set conditions in relation to both the structure and the application of the materiality threshold. This harmonisation is necessary in order to ensure a consistent use of the materiality threshold and will help reduce the burden of compliance for cross-border groups.

The conditions set out in this consultation paper in particular require that competent authorities set a materiality threshold that is composed of both an absolute and a relative threshold. The absolute threshold refers to the amount of the credit obligation past due understood as the sum of all amounts owed by the obligor that are past due more than 90 days (or 180 days if the competent authority has decided to replace the 90 days with 180 days in accordance with Article 178(1)(b) of the CRR). The relative threshold is defined as a percentage of a credit obligation past due in relation to the total credit obligations of the obligor. In the case where either or both of those limits are breached a default would be considered to have occurred.

Based on these proposals for the draft RTS, competent authorities are required to set an absolute threshold for retail and for all other ('non-retail') exposures, which will apply to all institutions in a given jurisdiction. The absolute threshold cannot be higher than 200 EUR for retail exposures and 500 EUR for non-retail exposures. Similarly the relative threshold must be lower or equal to 2%. These upper bounds on the thresholds both ensure sufficient conservatism and harmonisation with regard to the levels of the thresholds across jurisdictions. Further, the proposed draft RTS set forth the considerations that should be taken into account by the competent authorities when setting the level of the threshold, such as the characteristics of the obligors and transactions, default and cure rates and market practices of the institutions.

It is expected that the implementation of these proposed draft RTS might have significant impact on the operations of some institutions. In particular for those institutions that use the IRB approach and where the threshold will change significantly, the implementation of the necessary adjustments may require some time. Hence the additional conditions proposed that competent authorities allow longer ‘transitional’ periods to certain types of firms. However, those periods should be reasonably limited.

3. Background and rationale

The definition of default including the concept of materiality threshold set by competent authorities has already been introduced by Directive 2006/48/EC of 14 June 2006 (part of what was known as the Capital Requirements Directive - CRD), later replaced by Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR). The materiality thresholds are used not only for the purpose of IRB Approach but apply also to the institutions that use the Standardised Approach. However, in the absence of specific rules on the structure and application of the materiality threshold, various approaches have been adopted across jurisdictions. As a consequence a wide range of practices has been observed.

In the majority of jurisdictions specific rules have been adopted concerning the materiality threshold. These rules usually are in the form of hard limits, either in relative terms or in absolute terms or a combination of the two. The relative thresholds are usually not differentiated between the types of exposures or obligors. The limits range from 2% to 5% of the exposure. The absolute thresholds differ significantly between countries and range from 15 EUR to even 50.000 EUR.

Furthermore practices differ substantially on the structure. Firstly, some competent authorities set different absolute thresholds for retail and non-retail portfolios. Secondly, in some jurisdictions the materiality threshold is not used, hence if any amount is past due more than 90 days the exposure is considered defaulted. Thirdly, some competent authorities did not set explicit limits but allow the institutions to define their own limits and make case-by-case evaluations, which have led to significant variation across institutions even within the same jurisdiction. Finally, some jurisdictions have also applied a threshold specifically to remove so-called technical defaults from data series used to estimate IRB models. Hence a common understanding of the concept of a materiality threshold is necessary in order for competent authorities to set the threshold.

Apart from different structures and levels of the thresholds there are also significant differences with regard to the reference amount that is compared with the threshold and the counting of days past due. In a few jurisdictions it is allowed that the days past due are counted only from the day that the amount past due becomes material regardless of the contractual obligations. In that case the whole amount past due is taken into account. According to other approaches the reference amount compared with the materiality threshold could be the amount past due more than 90 days or the whole credit obligation. Each of those approaches is applied either to the total exposure of an obligor or separately to every facility of the obligor.

In the situation of such variety of approaches it was clear that any solution adopted in these proposed draft RTS would require significant adjustments in large part of the institutions. Therefore the development process was focused mainly on finding the best possible approach that would serve the objectives of the materiality threshold to avoid treating as real defaults such cases where the past due exposure is not a result of materialisation of credit risk but occurs due

to other circumstances. The materiality threshold should prevent from recognising too many defaults that will be cured in a short timeframe but at the same time the threshold should not prevent from timely identification of real default cases.

The structure and level of the materiality threshold may have significant impact on the own funds requirements. In particular, in the case of institutions that use the IRB approach, the classification of exposures as defaulted impacts not only the calculation of risk weights and expected losses for defaulted exposures, but indirectly also other exposures through its impact on PD and LGD models. In general, a lower materiality threshold results in more defaults being identified and subsequently the total of the expected and unexpected loss estimation is higher. Under the Standardised Approach the unsecured parts of defaulted exposures are grouped in the dedicated exposure class and receive a conservative risk weight.

Due to the potentially high impact of the structure and level of the materiality threshold as described above, it is important to ensure the level playing field across institutions, and within and across jurisdictions. Therefore the proposed draft RTS is based on a common structure of a threshold and requires that the single threshold should be applied to all institutions in a certain jurisdiction, as set out in the CRR. It is expected that the harmonisation of practices should reduce the burden for cross-border institutions to comply with different requirements in different Member States.

A basic decision that had to be taken in the development of these proposed draft RTS was the definition of the reference amount that the threshold should be compared with. Unification of approaches in that respect is crucial to ensure a minimum level of comparability across institutions and jurisdictions. The reference amount is also a basis for the meaningful calibration of the level of the threshold. The approach to the application of the materiality threshold as specified in these proposed draft RTS is planned to be subsequently consistently used in further related EBA work, in particular in the future EBA Guideline on the application of the definition of default.

It is proposed that in the assessment of the materiality of credit obligations past due only the amounts owed by the obligor that are past due more than 90 days (or 180 days if competent authority decided to replace the 90 days with 180 days in accordance with Article 178(1)(b) of the CRR) should be taken into account. In order to mitigate the risk of splitting the credit obligations into smaller portions or selective repayment of the obligations by the obligor in order to avoid the default being triggered, all amounts past due more than 90 days, irrespective of which credit obligation of the obligor they are related to, should be summed up and the sum should be assessed against the materiality threshold.

The threshold should be structured as a combination of an absolute and relative limit. The absolute component should be used as described in the previous paragraph. The relative component is a percentage of the sum of all amounts related with any credit obligation of a borrower that are past due more than 90 days (or 180 days if competent authority decided to replace the 90 days with 180 days in accordance with Article 178(1)(b) of the CRR) in relation to

the sum of all amounts of credit obligations of the borrower. In the case of retail exposures where the default definition is applied at the level of individual facility the sum of the amounts past due more than 90 days related to a single credit obligation (facility) of the obligor should be taken into account. For the purpose of a relative threshold this sum should be related to the value of this single credit obligation.

It is proposed that the obligor should be considered defaulted whenever either of the components of the threshold, i.e. absolute or relative limit, is breached. This approach is balanced and proportionate as, on the one hand, it takes into account the exposure value and, on the other hand, it is sufficiently prudent as it requires that in all cases the amounts above the absolute limit should be considered material.

Not only the structure but also the required level of the materiality threshold impacts the own funds requirements and may reduce the level playing field where thresholds are established by different competent authorities. While some differences in the levels of the thresholds are justified by the local particularities of each jurisdiction, a minimum level of harmonisation across the Union is also desirable to ensure that the rules adopted in each jurisdiction are sufficiently prudent. Therefore according to the proposed draft RTS competent authorities have flexibility in setting the level of the threshold up to a maximum level defined in the proposed draft RTS themselves.

It might be argued that the reasonable level of materiality threshold depends on the characteristics of the obligors and their exposures, hence several thresholds could be introduced dependent on different types of exposures. In order to ensure a reasonable balance between the simplicity of the framework, that would be sufficiently operational from the implementation perspective, and risk sensitivity, it is proposed to allow the competent authorities to set different absolute thresholds for retail and all other, i.e. non-retail exposures. Between retail and all other exposure classes the most significant differences in average income and exposure values are observed and the classification is readily available for all institutions, irrespective of the approach used for the purpose of own funds requirements calculation. The proposed structure of the threshold is assessed to take into account the substantial differences between retail and non-retail exposures, while at the same time not adding too much complexity.

The level of the materiality threshold should reflect a level of risk that the competent authority considers to be reasonable. In assessing the reasonable level of risk, it is proposed that competent authorities take into consideration various factors relevant for the institutions in their respective jurisdiction. In their analysis, competent authorities should take into account the range of institutions within their jurisdictions, the availability of specific information and the quality of available data. To ensure common understanding of the sources of risk and the factors that may have an impact on the reasonable level of risk covered by the materiality threshold the proposed draft RTS specify the areas that should be analysed by the competent authorities in order to set the level of the threshold. It is expected that some institutions might not be able to apply the threshold set by the competent authority at the date of application of the RTS. In particular the implementation process might be operationally cumbersome for institutions that use the IRB

approach, which is already based on existing definitions and that. The change in the materiality threshold will in consequence be a change in the default definition used for the development of the models. Consequently this will entail an adjustment to the risk parameters, which will have to be recalibrated to reflect the changes. Additionally, any changes in the definition of default are considered to be material changes to the rating systems, therefore an approval of a competent authority will be required for the changed rating systems. Also the implementation process might be more burdensome for the institutions that currently use a significantly different approach with regard to the materiality of past due exposures. It is therefore proposed that such considerations should be taken into account by competent authorities when defining the timeline for the implementation of the threshold for categories of particular institutions. in their jurisdiction. However in order to prevent excessive delays in the implementation of the threshold across the EU, such 'transitional' periods for firms should be reasonably limited.

4. Draft regulatory TS on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013

In between the text of the draft RTS that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

COMMISSION DELEGATED REGULATION (EU) No .../..

of **XXX**

[...]

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for the materiality threshold of credit obligation past due under Article 178 (6)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26/06/2013 on prudential requirements for credit institutions and investment

firms and amending Regulation (EU) No 648/2012¹, and in particular the third subparagraph of Article 178(6) thereof,

Whereas:

- (1) Due to similar market and economic conditions in the same jurisdiction, it would be appropriate for competent authorities to set a single threshold for the assessment of materiality of a credit obligation past due for all institutions incorporated in their respective jurisdictions. Such a threshold, that is expected to remain consistent over time, would bring the added benefit of increased comparability of capital requirements among institutions in the same jurisdiction and would facilitate the operation of mergers and of institutions belonging to groups.
- (2) On the one hand, given that the materiality threshold is dependent on the level of risk that the obligations past due represent, for individual obligors or exposures, the amount that can be considered material depends on the level of the overall credit obligation. On the other hand, in practice, institutions tend to consider all amounts above a certain level as material, regardless of their relation to the overall credit obligation. As a consequence, the threshold to be set by a competent authority should be based on both of the above considerations and consist of two components: an absolute component (i.e. an absolute amount) and a relative component (i.e. the percentage of the whole credit obligation that the amount past due represents), whereby exceeding the limits of either of those components would result in the obligation past due being considered material.
- (3) There are significant differences in the average income and average amounts of credit obligations between various types of obligors; as a result the materiality of amounts past due in terms of the level of risk they represent, should also be differentiated accordingly. In order to reflect this need for risk sensitivity and combine it with simplicity of the framework, it would be appropriate to set the absolute component of the threshold at different levels for retail exposures and for all other exposures, separately, where the determination of retail exposures is made in the manner referred to in Article 147 of Regulation (EU) No 575/2013, for banks applying the IRB approach, and in the manner referred to in Article 112 of that Regulation for institutions that apply the Standardised Approach.
- (4) While there is a need to ensure that the materiality threshold adapts to the local particularities of each jurisdiction, an adequate level of harmonisation across the Union is also desirable. As a result, rules on the setting by competent authorities of the materiality threshold for credit obligations past due for the purpose of identification of default should specify a maximum level for the threshold.
- (5) The materiality threshold may have a significant impact on the calculation of capital requirements and expected losses. Further, the threshold to be set by a competent authority is expected to affect all institutions in that jurisdiction irrespective of the method used for calculating their capital requirements. For these reasons, the level of the materiality threshold should be carefully calibrated by competent authorities, based on a variety of factors. As a result, rules on the setting

¹ OJ L 176, 27.6.2013, p. 1.

by competent authorities of the materiality threshold for credit obligations past due for the purpose of identification of default should also specify the factors that competent authorities should consider in their calibration of the threshold.

- (6) Due to the comprehensive analysis that needs to be carried out by competent authorities in order to define the appropriate level of materiality thresholds, adequate time should be allowed to them for setting the threshold.
- (7) In order to apply the materiality threshold set by competent authorities, some institutions that use the IRB approach might require changes to their IRB models. Such changes are expected to be material changes to the models, requiring prior approval by the competent authority. For other institutions, the implementation of the materiality threshold set by competent authorities might be burdensome if their previous approach for determining the materiality of exposures past due is significantly different from that threshold. As a result, it would be desirable for competent authorities to provide, in their respective jurisdictions, longer periods for the application of the threshold to certain categories of firms, based on the principle of proportionality. On the other hand, and in order to prevent excessive delays in the implementation of the threshold across the Union, such longer periods should be limited to a maximum of two years from the date of application of this Regulation.
- (8) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.
- (9) The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010²,

HAS ADOPTED THIS REGULATION:

Article 1

Competent authorities shall set the threshold referred to in paragraph 2(d) of Article 178 of Regulation (EU) No 575/2013 in accordance with the conditions specified in Articles 2 and 3.

Article 2 – Characteristics of the threshold

1. For the purposes of setting the threshold referred to in Article 1, competent authorities shall set a single threshold for all institutions in the respective Member State.

² Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

2. For the purposes of setting the threshold referred to in Article 1, competent authorities shall set a threshold consisting of an absolute and a relative component whereby:
 - (a) the absolute component of the threshold shall be set as a limit to the sum of all amounts that are past due more than 90 days or 180 days where the competent authority has replaced the 90 days with 180 days in accordance with Article 178(1)(b) of Regulation (EU) No 575/2013 related to the credit obligations of the borrower to the institution, the parent undertaking or any of its subsidiaries ('credit obligation past due');
 - (b) the relative component of the threshold shall be set as a percentage of the credit obligation past due as referred to in point (a) in relation to the total amount of all credit obligations of the borrower;
 - (c) where either or both of the limits referred to in points (a) and (b) is breached, the credit obligation past due shall be considered material, and the obligor shall be considered defaulted.

Explanatory text for consultation purposes:

The objective of the materiality threshold is to identify and exclude the so called 'technical defaults' i.e. small amounts that are past due as a result of technical circumstances rather than the financial situation of the obligor, which is what should drive the materiality of default. At the same time the materiality threshold should not prevent the timely identification of real defaults that result from the credit risk of the obligor. Therefore the materiality threshold should strike the appropriate balance in distinguishing the 'real' and 'technical' defaults and thereby ensuring a prudentially sound approach. For that purpose it is proposed that a combination of an absolute and relative threshold must be used.

According to the proposal (option 1), default should be identified when either of those limits is breached. This approach is restrictive for small exposures and might result in a substantial number of 'technical defaults' treated as real defaults. On the other hand it should be effective in the case of larger exposures and prevent the delay in recognition of default.

As an alternative option (option 2) it was considered to identify default only after both limits are breached. This approach would better identify technical defaults in the case of very small exposures, however it could lead to significant delays in default identification with regard to large exposures and in particular in the case of products based only on interest payments.

Q1. Do you agree with the approach proposed in the draft RTS (option 1) that default should be recognized as soon as one of the components of the threshold (absolute or relative limit) is breached? Or would you rather support the alternative option, i.e. recognition of default after both thresholds are breached (option 2)?

3. In the course of setting the limit to the credit obligation past due as referred to in point (a) of paragraph 2, the following conditions shall apply:
 - (a) competent authorities shall take into account possible differences in risk characteristics between retail and all other exposures;

- (b) competent authorities shall set a limit that is lower or equal to 200 EUR or the equivalent of that in the relevant national currency for retail exposures, and 500 EUR of the equivalent of that in the relevant national currency for all other exposures.
4. In the course of setting the percentage of the credit obligation past due relative to the total amount of all credit obligations, as referred to in point (b) of paragraph 2, competent authorities shall set a percentage that is lower or equal to 2% of the total amount of all credit obligations of the borrower .

Explanatory text for consultation purposes:

Q2. Do you agree with the proposed maximum levels of the thresholds?

5. Competent authorities may set a separate threshold for those institutions that apply the definition of default at the level of individual credit facility in accordance with the second subparagraph of Article 178 (1) of Regulation (EU) No 575/2013. Where they decide to set such a threshold, competent authorities shall do so under the same conditions as those referred to in paragraphs 2 to 4, with reference to the sum of all amounts of credit obligations past due of the obligor that result from a single credit facility.
6. In the course of setting the threshold referred to in paragraph 5, the following conditions shall apply:
- (a) the absolute component of the threshold shall be set as a limit to the sum of all amounts of the credit obligation of the borrower to the institution, the parent undertaking or any of its subsidiaries that result from a single credit facility and that are past due more than 90 days or 180 days if the competent authority has replaced the 90 days with 180 days in accordance with Article 178(1)(b) of Regulation (EU) No 575/2013;
 - (b) the relative component of the threshold shall be set as a percentage of the sum of the amounts referred to in letter (a) in relation to the total amounts of the credit obligation that result from a single credit facility.

Article 3- Setting the level of the threshold

In the course of setting the threshold referred to in Article 1, competent authorities shall take into account the following factors in relation to their jurisdiction:

- (a) the average exposure and expected loss for different types of obligors and products across institutions;
- (b) types of products used by the institutions, including different maturities, repayment schemes and distribution of instalments during the repayment period;

- (c) the default and cure rates that could potentially result from the application of different potential thresholds across institutions;
- (d) the relevant internal procedures of the institutions for determining the amounts that are treated as material in their internal monitoring and recovery processes.

Article 4- Application of the threshold

In the course of setting the threshold referred to in Article 1, where competent authorities define timelines after which such threshold shall apply to institutions, competent authorities shall ensure:

- (a) that a longer period for the application of the threshold is provided for institutions in order for them to be able to adapt their systems with the view to complying with the threshold, depending on their specific circumstances and, in particular, for the following types of institutions:
 - (i) institutions using the IRB approach;
 - (ii) institutions applying numerous or complicated rating systems in the course of the calculation of their own funds requirements for credit risk;
 - (iii) institutions previously applying significantly different thresholds for materiality of obligations past due than those established by the relevant competent authorities in accordance with point (d) of Article 178(2) of Regulation (EU) No 575/2913.
- (b) that the period referred to in point (a) is not longer than [X] from the date of application of this Regulation.

Explanatory text for consultation purposes:

The EBA is aware that implementing the materiality threshold is likely to have a substantial operational impact, especially on IRB models. Consequently it appears justified to allow institutions a period of time for implementing the provisions outlined in these proposed draft RTS. Therefore the EBA intends to introduce clarity in the final RTS on when the competent authorities have to ensure that the threshold is fully implemented by the institutions. Consequently, the EBA is asking for input on the appropriate period of time needed for institutions to fully implement the proposal, having in mind that institutions must have robust time series with a new classification of defaults for IRB models.

Q3. How much time is necessary to implement the threshold set by the competent authority according to this proposed draft RTS? What is the scope of work required to achieve compliance?

Article 5

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

It shall apply from *[instructions to the OJ: please insert the date that corresponds to 90 days after the date of publication in the OJ]*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

*For the Commission
The President*

*[For the Commission
On behalf of the President*

[Position]

5. Accompanying documents

5.1 Impact Assessment on the RTS on the materiality threshold for past due exposures

1. Introduction

Article 178(6) of the Regulation (EU) No 575/2013 requires the EBA to develop draft regulatory technical standards (RTS) to specify the conditions according to which competent authorities shall set the threshold against which the institutions shall assess the materiality of a credit obligation past due. This threshold shall reflect a level of risk that the competent authorities consider reasonable.

As per Article 10(1) of the EBA regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any RTS developed by the EBA – when submitted to the EU Commission for adoption - shall be accompanied by an Impact Assessment (IA) annex which analyses ‘the potential related costs and benefits’. Such annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.

This annex presents the IA with cost-benefit analysis of the provisions included in the RTS described in the present Consultation Paper.

2. Problem definition

The primary problem that the current RTS aim to address is the lack of common practice and variations in the interpretation across Member States when institutions apply and competent authorities assess the application of the materiality threshold. The provision under Article 178 on the application of the materiality threshold is stated in relatively broad terms, therefore are open to interpretation.

A common and consistent application of the threshold is central because the definition of default of an obligor is directly related to the definition of materiality and hence that of threshold. In other words, the threshold that the institutions apply and which defines the materiality of credit obligation has a direct impact on the calculation of own fund requirements of the institutions. This is true for all banks using internal ratings based (IRB) approach or standardised approach

(SA). Precisely, materiality threshold has an impact on institutions' own fund requirements through the classification of exposures as defaulted or non-defaulted. Section 6 provides a more detailed discussion on the impact of the materiality threshold on the own fund calculations and requirements of the institutions.

Lack of common and consistent application of the materiality threshold may further lead to uneven playing field across Member States and institutions. For example, two institutions located in different jurisdictions with similar risk profiles may be subject to different regulatory treatment if the default definition and the materiality thresholds are not consistent between jurisdictions. Similarly, different treatment of various entities belonging to the same cross-border groups due to different supervisory practices may lead to significant operational burden for the group and uneven playing field in the EU banking sector.

3. Objectives

The objective of the RTS is to establish convergence of supervisory practices regarding the application of materiality threshold for past due credit obligation. Harmonisation of the current practices that vary across Member States and institutions is expected to enhance comparability of own funds and own funds requirements and to reduce the burden for cross-border institutions to comply with different regulatory frameworks.

The RTS in addition aim to set the conditions for materiality threshold in a way to address the situations where the past due exposure is a result of materialisation of credit risk and not due to other circumstances. The materiality threshold should allow the timely identification of default cases that are generated from the materialisation of credit risk and eliminate the recognition of a large number of defaults that will return to a non-defaulted status in a short timeframe. In particular, the materiality threshold should not prevent from identifying defaults on the basis of an indicator that the payments are delayed for more than 90 days.

In the case of institutions that use IRB approach the objective of the materiality threshold is also to contribute to the accurate estimates of the risk parameters. If the defaults that occur from circumstances other than the materialisation of credit risk are effectively cut off by the materiality threshold, then the quality of data used for modelling is expected to be higher and the model development process is expected to be more transparent with no further data adjustments required. On the other hand, all defaults due to the materialisation of credit risk should be effectively identified to ensure sufficient level of data quantity and accuracy of estimates.

4. Baseline scenario

EBA prepared surveys³ to collect information from the competent authorities. A total of 22 Member States participated in at least one of the surveys and the basis of the baseline scenario is the responses to these surveys together with additional inputs from the task force members. The baseline information is the benchmark to assess the potential costs and benefits that the Member States will be subject to under the technical options. In other words, if the current practices in the Member States are the same as or similar to the elements that are considered in the current RTS, the expected costs and benefits are smaller than when the current practice is very different than the final policy decision taken under the RTS.

Available information shows that there are great variations across Member States in the application of the materiality threshold. Current section aims as much as possible to describe the current practices across Member States in the parameters and elements in the application of the materiality threshold, including:

- Credit obligation past due definition,
- Structure of the threshold,
- Differentiation criteria, and
- Current level of threshold as a benchmark for cap threshold at the EU level.

Some competent authorities issued binding rules for the institutions while the others granted the institutions more flexibility in the application of the materiality threshold. The thresholds are defined either in absolute or relative terms or constitute a combination of the two criteria (see Table 1). The levels of the thresholds range from €0 to €50,000 for absolute limits and if specified, they range from 1% to 5% in relative terms.

Apart from different structures and levels of the thresholds there are also significant differences with regard to the reference amount that is compared with the threshold and the counting of days past due. In some cases materiality of exposures past due is defined on the basis of the past due amounts with the variety of options with regard to the counting of days past due and treatment of individual facilities. In other cases the materiality is related to the total obligations of the obligor. In some Member States it is allowed that the days past due are counted only from the day that the amount past due becomes material regardless of the contractual obligations. In that case the whole amount past due is taken into account. In some other cases the reference amount compared with the materiality threshold could be the amount past due more than 90 days or the whole credit obligation. Each of those approaches is applied either to the total exposure of an obligor or separately to every facility of the obligor.

³ Questionnaire distributed among TFMV members – paper number TFMV/2014/39 (April 2014) and the survey prepared by the EBA for the NCAs (June 2013).

In terms of differentiation criteria, the current practice show that the precise level at which the credit obligation past due becomes material depends on specific circumstances. In order to accommodate the differences in the characteristics of the banking systems, the CRR requests the competent authorities to set thresholds that are reasonable in their jurisdictions. Most Member States apply the criteria on an ad-hoc basis or make the differentiation between retail and non-retail exposures. Some Member States do not apply any criteria to differentiate between different types of exposures. Similarly, there is a wide variety of threshold values that are used by the institutions in different jurisdictions. While some of the differences are justified by the characteristics of the jurisdictions, where such justification seems to be missing significant outliers were also identified.

Table 1 presents an overview of the current practices across Member States in relation to the technical options considered in the assessment of the RTS. The findings show that:

- Under each technical area, case-by-case approach is the second most frequent practice across Member States,
- Most common past due definition is “the sum of the amounts past due more than 90 days (or 180 days if applicable) but the calculation of days past due starts when the materiality threshold is breached”,
- In terms of the structure of the threshold, the majority of the Member States use the combination of absolute and relative thresholds, and an obligor is in default if any of the two thresholds is breached,
- Most of the Member States differentiate the threshold for retail exposures from that of non-retail exposures.

Table 1: Current practices in Member States in relation to the technical options considered in the Impact Assessment (IA)

	AT	CZ*	DE	DK	EE	GR	ES	FR	HU	CR	IE	IT	LT	LU	LV*	NL	PL	PT	SE	SI	SK*	UK
Past due definition																						
Option 1: the whole single credit obligation if any part of it is past due more than 90 days (or 180 days if applicable)																						✓
Option 2: the sum of all amounts past due if any of the amounts is past due more than 90 days (or 180 days if applicable)																						
Option 3: the sum of the amounts past due more than 90 days (or 180 days if applicable)																						
Option 4: the sum of the amounts past due more than 90 days (or 180 days if applicable) but the calculation of days past due starts when the materiality threshold is breached	✓	✓	✓							✓				✓				✓		✓	✓	
Option 5: the amount past due more than 90 days (or 180 days if applicable) on an individual credit facility																						
Option 6: the amount past due on an individual credit facility if any part of this amount is past due more than 90 days (or 180 days if applicable)																						
Other									✓													
Case-by-case approach					✓		✓	✓			✓				✓	✓			✓			
Structure of the threshold																						
Option 1: absolute amount threshold		✓		✓													✓	✓			✓	✓
Option 2: relative threshold												✓										
Option 3: combination of absolute and relative threshold	✓		✓			✓			✓	✓			✓	✓						✓		
Option 3a: breach of at least one of the limits (absolute or relative) triggers default						✓			✓				✓									
Option 3b: breach of both limits triggers default	✓		✓							✓										✓		
Case-by-case approach					✓		✓	✓			✓				✓	✓			✓			
Differentiation criteria																						
Option 1: Single, not differentiated threshold for all exposures	✓												✓							✓		
Option 2: Differentiation of the threshold for retail and non-retail exposures		✓	✓	✓					✓	✓				✓			✓	✓			✓	

Option 3: Differentiation of the threshold for retail and non-retail exposures with additional differentiation of product types for retail exposures						✓													✓			
Case-by-case approach					✓		✓	✓			✓				✓	✓						✓

Source and notes: The results of the survey prepared by the EBA for the NCAs (June 2013) and additional information provided by TFMV members

*Source: questionnaire distributed among TFMV members – paper number TFMV/2014/39 (April 2014)

Member States that are not included in the table, did not participate the survey except LV which stated that the regulation does not go beyond CRD and LV hosts only two foreign banks that use IRB approach.

Blank cells: MS did not provide information in the survey.

5. Assessment of the technical options

Current section presents the assessment of the technical options considered in the RTS. Under each option, the potential advantages and disadvantages of the options together with potential costs and benefits are discussed.

a. Definition of credit obligation past due

Option	Advantages	Disadvantages
1 The whole single credit obligation if any part of it is past due more than 90 days (or 180 days if applicable)	<ul style="list-style-type: none"> - Very conservative approach towards larger exposures and therefore encourages close monitoring and management of the exposures. - Simple and easy to implement. 	<ul style="list-style-type: none"> - Default identification process does not account for small credit obligations. - Too restrictive in the case of large exposures. - The material default is not identified if a large exposure is divided into many small exposures, each falling below the threshold. - Rare practice among Member States, i.e. only two Member States are currently using the approach.
2 The sum of all amounts past due if any of the amounts is past due more than 90 days (or 180 days if applicable)	<ul style="list-style-type: none"> - More prudent approach than option 3 that allows the default to be identified sooner because it takes into account all amounts past due even before they reach 90 DPD. 	<ul style="list-style-type: none"> - Cliff effect might occur in the situation when an obligor has a very small unpaid amount on some account. In such case the delay in payment of an instalment of credit obligation even by one day would trigger default. - This approach might raise doubts about the calculation of days past due: if the calculation of days past due starts after materiality threshold is achieved then the cliff effect is avoided but the DPD is not compliant with contractual obligation and other purposes where DPD number is used.
3 The sum of the amounts past due more than 90 days (or 180 days if applicable)	<ul style="list-style-type: none"> - Approach that is commonly used across Member States. - The cliff effect is effectively avoided (see explanation for the disadvantages under option 2). - Effective in the identification of technical defaults that result from errors in IT systems or misunderstandings with the clients rather than realisation of credit risk and therefore it should enhance the quality of internal estimates by avoiding extensive cure rates. 	<ul style="list-style-type: none"> - Less prudent approach in comparison with options 1 and 2. - Problematic in the case when only interests are paid on a monthly basis. It is possible that the exposure is past due for many months before materiality threshold is breached.

<p>4 The sum of the amounts past due more than 90 days (or 180 days if applicable) but the calculation of days past due starts when the materiality threshold is breached</p>	<p>- Same arguments as under option 3 (the approach gives the same results as option 3).</p>	<p>- Same arguments as under option 3.</p> <p>- The counting of DPD is not compliant with contractual obligations of the institution and other purposes where DPD number is used, in particular internal monitoring of credit portfolio.</p>
<p>5 The amount past due more than 90 days (or 180 days if applicable) on an individual credit facility</p>	<p>- Same arguments as under option 3.</p>	<p>- Same arguments as under option 3.</p> <p>- Reflects the risk of a facility rather than an obligor.</p> <p>- In the case a large overall exposure, a material default might not be identified if it is split into several facilities.</p>
<p>6 The amount past due on an individual credit facility if any part of this amount is past due more than 90 days (or 180 days if applicable)</p>	<p>- Same arguments as under option 2.</p>	<p>- Same arguments as under option 2.</p> <p>- Reflects the risk of a facility rather than an obligor.</p> <p>- In the case a large overall exposure, a material default might not be identified if it is split into several facilities.</p>

Given the advantages and the disadvantages of the options, the preferred option is the technical option 3. The preferred option seems to reflect the intention of Article 178 and it is the approach that is commonly used across Member States therefore it is expected to generate on aggregate least cost for the Member States. At the same time this interpretation helps to effectively achieve the objective of the materiality threshold to prevent from recognising too many defaults that will be addressed in a short timeframe without avoiding the identification of real material defaults.

b. Structure of the threshold

Option	Advantages	Disadvantages
<p>1 Absolute threshold</p>	<p>- Conservative approach, all amounts above this threshold are considered material regardless of the size of the obligor or total exposure.</p> <p>- Absolute threshold is effective in cutting off technical defaults.</p> <p>- Simple approach, easy to implement.</p>	<p>- Does not respect proportionality: approach more conservative for larger exposures, where default would typically be identified straight after 90 days past due. On the other hand in the case of small exposures default might not be identified even after many days past due.</p>
<p>2 Relative threshold</p>	<p>- Accounts for basic characteristics of specific obligors.</p>	<p>- Approach generous for large exposures and for obligors that use numerous facilities. In that case failure to repay one facility might not cause the default of the obligor.</p>
<p>3 Combination of absolute and relative thresholds</p>	<p>- Allows for effective cut-off points for technical defaults.</p>	<p>- Relatively more complex approach hence more difficult in implementation.</p>

		- More risk sensitive as it accounts for the characteristics of particular exposures.	
3a	Breach of only one threshold triggers default	<ul style="list-style-type: none"> - All exposures above each component of the threshold are considered material. - More prudent approach. 	<ul style="list-style-type: none"> - Some technical default might not be cut off, for example in the case of very small exposures like unpaid fees the whole amount is past due and therefore default would be triggered by the relative component of the threshold.
3b	Breach of both thresholds triggers default	<ul style="list-style-type: none"> - All exposures below each component of the threshold are considered immaterial. - Ensures that very small exposures are not taken into account in the identification of default. 	<ul style="list-style-type: none"> - Approach generous for large exposures and for obligors that use numerous facilities. In that case failure to repay one facility might not cause the default of the obligor until the relative component of the threshold is breached. - Some material defaults might not be identified in a timely manner and cause underestimation of risk by the institution.

The analysis of advantages and disadvantages of the possible structures of the threshold shows that none of these approaches is free from certain weaknesses. Nevertheless, it is impossible to assess the materiality of each exposure individually therefore some degree of simplification is inevitable. Technical option 3a is selected to be the preferred option. It seems to be sufficiently risk sensitive and at the same time prudent enough to account for those simplifications.

c. Differentiation criteria

Option	Advantages	Disadvantages
1 No differentiation: single threshold criterion for all exposures	<ul style="list-style-type: none"> - Reasonable under the assumption that regardless of the type of client or product certain very small amounts are immaterial for the institution. - Simple and easy to implement. 	<ul style="list-style-type: none"> - Lack of risk sensitivity (see rationale for options 2 and 3)
2 Differentiation of the threshold for retail and non-retail exposures	<ul style="list-style-type: none"> - As opposed to option 1 it could be argued that from the perspective of the institution immaterial amounts are those that the average cost of collecting would exceed the amount. However in the case of retail exposures the amounts are individually smaller but there is a significant number of similar exposures. The collection processes are less individual and therefore the costs of recovery of a single exposure are on average lower. That would justify differentiation between retail and non-retail exposures. - The average exposure values of retail and non-retail clients are 	<ul style="list-style-type: none"> - The approach does not take into account differences between the product types used by retail clients (in particular mortgage loans and other loans) in the case when the default definition is applied at the level of individual facility.

	significantly different.	
	- The approach is still simple and easy to implement. The classification into retail and non-retail exposures is readily available for all institutions, regardless if they use IRB or Standardised Approach.	
3	<p>Differentiation of the threshold for retail and non-retail exposures with additional differentiation of product types for retail exposures</p> <p>- Enhanced risk sensitivity by taking into account significant differences in characteristics between retail product types.</p> <p>- In the case of retail exposures the application of the default definition at the level of individual facility is the most common approach among institutions therefore the specificities of product type can be considered to be an important risk factor.</p>	<p>- The recognition of the types of products for the purpose of IRB and Standardised Approach are significantly different. The class of exposures secured by mortgages on immovable property include only those parts of exposures that are fully and completely secured by such mortgage. This class does not refer to the type of obligor and therefore may contain exposures to both retail and non-retail clients. Under the IRB approach the exposures secured by immovable property are recognised only within the retail exposure class and they include the whole credit obligations regardless of the part of the obligation that is secured fully and completely. Those exposures are therefore incomparable. Additionally under IRB approach also qualifying revolving retail exposures are recognised, whereas in the Standardised Approach such category does not exist.</p>

Option 2 offers the reasonable balance between the simplicity and risk sensitivity by recognising the most important factor of differentiation that is easy to implement and comparable for all institutions regardless of the approach used to calculate own funds requirements. The preferred option is therefore technical option 2.

d. Cap threshold

Option	Advantages	Disadvantages
1 No cap threshold	<ul style="list-style-type: none"> - No need for calibration of a cap threshold on the European level. - Full flexibility for competent authorities. 	<ul style="list-style-type: none"> - Limited harmonisation and less comparability of own funds requirements. - Possibility of significant outliers.
2 Cap threshold specified in the RTS as a specific amount (equivalent in Euro)	<ul style="list-style-type: none"> - Simple and easy to apply. - Enhanced harmonisation and comparability of own funds requirements by avoidance of significant outliers. 	<ul style="list-style-type: none"> - Difficulty to calibrate a cap threshold that would be equally suitable for all jurisdictions. - In the case of non-Euro zone countries high volatility of foreign exchange rates may lead to non-compliance of the threshold set in a local currency.
3 Cap threshold defined as a formula that takes into account the characteristics	<ul style="list-style-type: none"> - Better adjustment of the cap threshold to the specificity of a certain jurisdiction. 	<ul style="list-style-type: none"> - Difficulty to define a formula that would take into account the most important factors.

of a certain jurisdiction

- Difficulty to implement the threshold and to monitor ex-post compliance.

- Possible necessity to change the threshold once the cap ceases to be met.

Option 2 is the preferred option because it allows achieving the main goal to be served by the cap threshold in a simple fashion and easy in implementation. The option is sensible in order to grant the competent authorities the flexibility in calibrating the levels of the threshold that accommodate the characteristics of the banking sector and at the same time to ensure the implementation of sufficiently prudent rules, and avoid significant outliers.

6. Impacts of the technical options

Under the SA, Article 127 of Regulation (EU) No 575/2013 groups the unsecured parts of defaulted exposures as a specific asset class. Within this asset class the risk weight is assigned according to the ratio between the unsecured part of the exposure value and specific credit risk adjustments. If the specific credit risk adjustments are equal to or greater than 20% of the unsecured part of the exposure value then the assigned risk weight is 100%. The assigned risk weight is 150% if the specific credit risk adjustments are less than 20% of the unsecured part of the exposure value. In other words, the lower the materiality threshold the higher the level of defaulted exposures in the asset class where higher risk weights are assigned, and higher risk weights adjust the own funds requirements calculation.

Under the IRB approach the materiality threshold has an impact on the classification of exposures as defaulted with the probability of default (PD) that is equal to 100%, which therefore has an impact on the calculation of expected loss (EL) and own funds requirements that represent the unexpected loss. Assets classified as not defaulted exposure are subject to standard formula with regard to risk weight calculation and for exposures classified as defaulted, usually lower risk weights are applied. For the Fundamental IRB (FIRB) approach the risk weight of defaulted exposure is set to zero. However the calculation of expected loss is based on PD that is equal to 100%, therefore it is much higher than if the exposure was not classified as defaulted. The lower the threshold, the higher is the expected loss. If the expected loss is not fully covered by the credit risk adjustments then the difference is deducted from own funds. For the Advanced IRB (AIRB) approach the logic is the same except that the risk weight for defaulted exposure is not zero but is calculated on the basis of the loss given default (LGD) parameter.

In addition, the default definition and in particular the materiality threshold that is defined under the default definition influence the own funds requirements of the IRB institutions through the application of PD and LGD parameters. Lower thresholds will result in relatively higher default

rate and PD estimates. However, not all of the identified defaults generate losses so this can decrease the LGD estimates of the AIRB institutions.

It is difficult at this point to assess the impact of the draft RTS on EL and capital requirements of the institutions because the RTS only specify the criteria for setting the threshold but the levels that the competent authorities will set in this framework are still unknown.

In theory, the lower the threshold is, the more defaults are identified. Higher level of defaults generates higher EL and in the case of SA the credit risk adjustments are higher. The effect on the capital requirements however is not straightforward and depends on the method used by the institution to calculate capital requirements:

- In the case of the institutions that use the SA, higher rate of provisions results in lower risk weights for defaulted exposures (100% or 150%). As these are the highest levels of risk weights used in most of the other exposures classes it is reasonable to expect that the lower is the threshold, the higher is the risk weighted exposure amounts.
- In the case of the institutions that use FIRB Approach the risk weight of defaulted exposures is zero but the materiality threshold impacts also the risk weights of non-defaulted exposures through the PD estimates. Lower threshold results in higher default rate, higher PD estimates and higher risk weights for non-defaulted exposures.
- In the case of the institutions that use AIRB Approach the impact on the capital requirements is complex. Risk weight for defaulted exposure depends on the best estimate of EL and LGD estimates, and should represent the unexpected loss in the recovery process. It is not explicit whether the risk weight calculated in this way is higher or lower than the risk weight for non-defaulted exposure. This depends largely on the methodologies used by particular institutions. The materiality threshold impacts also the risk weights of non-defaulted exposures through PD and LGD estimates. With regard to PD it is clear that the lower the threshold the higher the PD estimates and risk weights. In the case of LGD however the impact would most likely be reverse, because lower threshold might result in more defaults that are cured in a short period of time. This effect would decrease the LGD estimates and the risk weights for non-defaulted exposures.

In the extreme circumstances if there were no materiality thresholds (levels of threshold set to zero) and all exposures that are past due more than 90 days were treated as defaulted the overall impact of expected loss and capital requirements should be conservative. Nevertheless if the materiality thresholds are too low then the main objective to identify and cut-off the technical defaults would not be met and it would have a negative impact on the quality of internal risk estimates. In that situation the institutions may have the incentives to perform additional adjustments and cleaning techniques in the historical data.

Costs for institutions

Baseline scenario shows that most of the policy decisions under the draft RTS are somehow in line with the current practices in Member States. This generates lower aggregate cost for the entire EU. However, under each technical option some regulatory changes will have to be introduced by the Member States, either with regard to the level of the threshold, its structure, application, reference amount or the approach towards the assessment of the institutions.

Currently most of the institutions already use some materiality thresholds. The thresholds are set either on the basis of regulations imposed by a competent authority or on the basis of own analysis of the institution, subject to assessment by a competent authority on an individual basis. Due to the fact that the range of practices with regard to the application of the threshold is very wide most institutions will have to introduce some changes. The change of the level and in particular structure of the threshold might have significant impact on the operations of the institutions. The impact and costs for particular institutions will depend on the currently implemented thresholds as well as the approach used in the calculation of own funds requirements.

Any changes in materiality threshold will affect in particular those institutions that use IRB approach. The risk parameters are estimated on the basis of historical data collected with the assumption of a certain materiality threshold. The consistency of the historical data with the default definition is crucial for the correct calibration of risk parameters. All historical data will therefore have to be adjusted to the new threshold and the parameters will have to be recalibrated to reflect the current default definition.

The adjustment of data and recalibration of risk parameters may impose a significant operational burden on the banks that use the IRB approach. In particular for those institutions that use numerous rating systems and where the concept of the threshold will change significantly, the process of implementing necessary adjustments might be costly and time consuming.

In the case of institutions that use the SA the impact of the change of materiality threshold will be relatively less significant as there will be no need to adjust historical data unless the institution will decide to apply for IRB approach in the future. Nevertheless in the case of those institutions for which the concept of materiality threshold will change significantly the costs might still be material. The change of the threshold might require the change in the current risk management processes and possibly also IT systems used to collect the data and calculate capital requirements.

Costs for national supervisory authorities

Article 178(2)(d) requires national supervisory authorities to define the threshold that reflects a level of risk that is considered to be reasonable and they need to account for various considerations in the regulatory framework. The analysis of the exposures, obligors, products, default history and the procedures used by the institutions will require the collection of relevant

data and significant analytical work. In order to grant the supervisory authorities sufficient time to conduct such analysis the date of application of these RTS is planned to be postponed by 3 months. It is however expected that the analysis will be a one-off assignment. Any modifications of the level of the threshold should not be introduced too frequently to avoid regulatory uncertainty for the institutions.

Additional impact for the national supervisory authorities will come with the applications from the institutions that were granted permission to use IRB approach for material changes of rating systems related with the change of materiality threshold in the default definition. For those institutions that will not be able to implement the changes before the application date of the new thresholds, competent authorities will have to review and agree on the plans of the institutions to return to full compliance and later verify the timely implementation of those plans.

The results of the EBA's recent investigation show that as of the end of 2011 there were 148 institutions that are using the IRB approach in 15 Member States. The figure includes global institutions (47), domestic sub-consolidated institutions (46) and domestic institutions (55)⁴. One third of the institutions in the overall sample are located in Germany. Therefore, it is reasonable to estimate that in the EU there are currently about 300 institutions that use the IRB approach⁵. If it is assumed that the majority of those institutions will have to seek approval of a competent authority for a material change of rating systems that results from the modification of default definition, granting such approvals in a timely manner might cause significant operational burden for the national supervisors.

Benefits

By establishing harmonised criteria for setting the materiality thresholds for past due exposures greater comparability of own funds requirements for credit risk will be ensured. Similar practices applied in all jurisdictions will also reduce the administrative and operational burden for cross-border institutions to comply with different regulatory frameworks in different Member States.

Transitional arrangements

Significant changes that will have to be introduced by some institutions with regard to data and rating systems might result in temporary non-compliance with the regulatory requirements. In the case of institutions that use IRB approach such situations should be dealt with in accordance

⁴ Global Institutions are those for which the NSA is the home regulator (the highest level of EU consolidation); domestic sub-consolidated Institutions are those for which the NSA is the host regulator (including non-domestic subsidiaries on solo basis); domestic Institutions are those for which the NSA is the sole regulator

⁵ The figure is estimated by the EBA team through a simple extrapolation of the available figures for an EU sub-sample with the assumption of 20% increase in the number of institutions that use IRB approach in the period of 2012 and 2013..

with Article 146 of Regulation (EU) 575/2013. In the case an institution needs more time to adjust the data, risk parameters or IT systems to comply with the materiality threshold set according to the criteria included in these RTS, it should do one of the following:

- notify and agree with a competent authority a plan for a timely return to compliance and consequently realise this plan within a period agreed with the competent authority;
- demonstrate to the satisfaction of competent authority that the effect of non-compliance is immaterial.

According to the RTS for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach (Regulation (EU) 529/2014), any changes in the definition of default should be considered material and as such require the approval of competent authority. Therefore it is highly unlikely that the latter option could be used in that situation. Rather the institutions will be expected to apply for permission prior the implementation of the changes in accordance with Article 143(3) of Regulation (EU) 575/2013.

It is expected that an institution that uses the IRB approach will submit one application to a competent authority that will encompass all modifications in the rating systems related with the change of materiality threshold in the default definition. Such application should include in particular the estimation of the impact of the change on the EL and risk weighted exposure amounts. In the case of some institutions the modifications might be implemented sequentially, therefore more than one application could be necessary. As a general rule however the change of default definition should be treated as one type of change even if it impacts multiple rating systems.

The time required to implement the changes should be proportionate to the scope of expected changes and complexity of the institution's rating systems. Nevertheless it is expected that the overall time for implementation of all changes, including the permission from a competent authority to implement material change, should be reasonably limited.

In the case of institutions that use the SA the implementation of the change in the default definition should be relatively easier. If however an institution will need more time in order to achieve full compliance, the timeline should be agreed with the competent authority and realised in line with the agreed schedule.

6.2 Overview of questions for Consultation

Q1. Do you agree with the approach proposed in the draft RTS (option 1) that default should be recognized as soon as one of the components of the threshold (absolute or relative limit) is breached? Or would you rather support the alternative option, i.e. recognition of default after both thresholds are breached (option 2)?

Q2. Do you agree with the proposed maximum levels of the thresholds?

Q3. How much time is necessary to implement the threshold set by the competent authority according to this proposed draft RTS? Given current practices, what is the scope of work required to achieve compliance?

Q4. Do you agree with the assessment of costs and benefits of these proposed draft RTS?

Q5. What is the expected impact of these proposed draft RTS?