
PEER REVIEW ON THE GUIDELINES ON THE APPLICATION OF THE DEFINITION OF DEFAULT (EBA/GL/2016/07)



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List of abbreviations

2SA	Two-step approach
AT	Assessment team
CA	Competent authority
CI	Credit institution
CRR	Capital Requirements Regulation
DpD	Days past due
ECB	European Central Bank
EEA	European Economic Area
DoD	Definition of default
JST	Joint supervisory team
GL	Guideline
IRBA	Internal ratings-based approach
IMI	Internal model investigation
LSI	Less significant institution
MS	Member State
NCA	National competent authority
NPL	Non-performing loan
PRC	Peer Review Committee
SSM	Single Supervisory Mechanism
OSI	On-site inspection
SA	Standardised approach
SAQ	Self-assessment questionnaire
SI	Significant institution
UTP	Unlikely to pay

Executive Summary

In the aftermath of the global financial crisis a harmonised definition of default was established in the EU as a key component in higher-quality and more uniform assessment of credit risk and calculation of risk-weighted assets, reducing the scope for regulatory arbitrage. The EBA was mandated to issue guidelines harmonising the definition of default of an obligor that is used for the purpose of the internal ratings-based approach for the calculation of capital requirements for credit risk as well as for the standardised approach.

The EBA Guidelines on the application of the definition of default ([EBA/GL/2016/07](#)) provide a detailed clarification of the definition of default and its application, covering key aspects such as the days past due criterion for default identification, indications of unlikelihood to pay, conditions for the return to non-defaulted status, treatment of the definition of default in external data, application of the default definition in a banking group and specific aspects related to retail exposures.

This report sets out the findings of the peer review of six CAs' supervision of credit risk, focusing on application of the definition of default and the EBA Guidelines across three major areas:

- implementation of EBA/GL/2016/07 in the supervisory framework;
- effectiveness of the procedure for the submission of the application;
- effectiveness of the assessment for checking compliance with the definition of default.

The peer review found that overall the Guidelines have been fully or largely incorporated into the supervisory framework by all supervisors reviewed.

The Peer Review Committee also found the effectiveness of supervision to be good, in particular as regards monitoring of IRBA credit institutions. While some EU IRBA banks are under the supervision of a national competent authority (in conjunction with the ECB), the majority are under the direct supervision of the ECB. The ECB has developed a detailed and thorough approach towards DoD supervision, including documentation for the submission of DoD applications.

Supervision of the definition of default of credit institutions using the standardised approach (SA) is good but more varied, reflecting the more dispersed nature of the credit institutions and the relative predominance of IRBA credit institutions in terms of size and assets in different jurisdictions, with some scope for consideration by competent authorities of best practices identified in the peer review and of the appropriate level of supervision in order to strengthen it further. This includes:

- considering and documenting the elements used to determine the basis of risk-based supervision of the definition of default and/or SREP assessments (e.g. ECB, LI, SI and SE);

- potential alignment of self-assessment questionnaires on DoD submitted to banks;
- consideration of the appropriate frequency and depth of assessments;
- establishing minimum checks on IT systems used by credit institutions to calculate elements of the definition of default;
- alignment of remedial actions in the context of local versus cross-border institutions.

In this context, it should be noted that at the European level (based on data at the end of 2023), banks without any approved IRBA portfolios (i.e. SA only) represent about 46% of the total number of banks, at the highest level of consolidation. In terms of total assets, these banks account for only 10.8% of the total assets at European level. For banks with at least one validated IRBA portfolio the percentage of banks under SSM supervision reaches 82.6%, and in terms of total assets and RWAs these banks account for 91.7% and 80.9% respectively. Consequently, the above proposed measures for the supervision of SA banks are deemed adequate.

The EBA will conduct a follow-up peer review of the implementation of the measures included in the report in two years.

1. Introduction

1.1 Role of peer reviews

One of the European Banking Authority (EBA)'s tasks is to conduct peer reviews of the activities of competent authorities (CAs), to further strengthen consistency and effectiveness in supervisory outcomes across the EU.

Peer review reports set out the main findings and conclusions gained from reviewing and comparing the application of certain (parts of) regulations, guidelines or general topics from a number of different CAs. They also identify follow-up measures for CAs that are considered appropriate, proportionate and necessary as a result of the peer review. Follow-up measures are of a general nature and are applicable to all CAs, including those that were not subject to this peer review, unless specified otherwise or not applicable in their jurisdiction (if, for example, the issue analysed does not exist).

A follow-up report undertaken two years after this report will assess the adequacy and effectiveness of the actions undertaken by CAs in response to these follow-up measures. The follow-up report could also cover those CAs that were not the subject of this peer review, and accordingly all CAs are invited to consider the findings of this peer report and any suggested follow-up measures.

1.2 Topic of this peer review

This peer review was performed on the basis of [EBA/GL/2016/07](#) which aims to harmonise the definition of default across the EU prudential framework and improve consistency in the way EU banks apply regulatory requirements to their capital positions.

In particular, the review focused on how CAs verify compliance by institutions with the specific rules and other aspects of the application of the definition of default set out in EBA/GL/2016/07 along the following lines:

- general questions on the implementation of the Guidelines on the definition of default (EBA/GL/2016/07);
- procedure for submitting an application for changes in the definition of default;
- assessment of the definition of default (at institution level in terms of effective compliance and application);
- assessment of the Guidelines on the application of the definition of default (at institution level in terms of effective compliance and application).

With regard to the regulatory aspects mentioned above, the peer review assessed whether:

- methodologies applied by the CAs ensure effective and consistent adoption of the DoD across institutions in their systems and processes;
- methodologies applied by the CAs ensure effective and consistent adoption of the DoD in institutions' internal models (only for IRBA banks);
- methodologies applied by the CAs ensure that institutions have integrated the DoD into their internal policies;
- the frequency and intensity of CAs' assessments are adequate.

1.3 Methodology

This is a targeted peer review focusing on six CAs (ECB/SSM, GR, LI, PL, SE and SI). Five CAs were selected based on the average percentage of non-performing loans (NPLs) in institutions' banking book within their jurisdiction, based on data as of 30 June 2023. On this basis GR, PL, LI, SE and SI were selected based on the following criteria:

- two CAs with the average highest percentage of NPLs ratio (GR, PL);
- two CAs with the lowest percentage of NPLs ratio (SE, LI); and
- one CA with an NPL ratio which is at the median of the distribution of the various European countries (SI).

In addition, the ECB/SSM was included in the sample given the breadth of credit institutions (CIs) under its supervision.

The criteria were chosen to be able to cover a diverse range of CAs and to be able to ultimately identify best practices at each end of the spectrum.

In terms of methodology, the peer review was performed by a Peer Review Committee (PRC) of EBA staff and CA staff (see Annex 1 for the composition) and covered the six CAs mentioned above (detailed in Annex 2).

The analysis has been conducted based on responses from CAs to a self-assessment questionnaire (SAQ), which covered a reference period (i.e. the period subject to review) based on the two-year period from January 2021 until December 2022.

Where necessary, the PRC followed up with the CAs in writing seeking further clarifications and explanations. The PRC also conducted bilateral follow-up interviews to gain a better understanding of issues unclear or not covered in the SAQ.

This report sets out the conclusions of the peer review together with follow-up measures that CAs need to take, all of which are aimed at further strengthening consistency and effectiveness in supervisory outcomes across the EU. It also identifies a number of best practices, the adoption of which might be of benefit for other CAs. As noted above, the actions taken by CAs in response to follow-up measures will be assessed in a follow-up report after two years.

The report consists of six chapters. Chapter 1 presents an overall introduction including a methodology. The report continues in Chapter 2 with some general explanations on the context of the peer review, in particular on i) the different supervisory set-ups in the Member States of the targeted CAs and ii) the individual specificities of the latter and the specificities of the individual banking sectors where necessary. Chapters 3, 4 and 5 look at the three different benchmarks to be evaluated under the peer review, presenting all relevant findings (including examples of application of the GLs) as well as drawing the conclusions from those findings. Chapter 6 provides overall conclusions, the resulting follow-up measures addressed to CAs and best practices of CAs.

1.4 Benchmarking

For the purposes of this peer review, three supervisory benchmarks were identified which were considered to reflect the key objectives of the peer review in terms of the expectations on CAs and their supervisory activities:

- implementation of EBA/GL/2016/07 in the supervisory framework;
- effectiveness of the procedure for the submission of the application;
- effectiveness of the assessment for checking compliance with the definition of default.

The PRC also identified individual criteria per benchmark that aim to set out the key factors used in reaching a judgement on the effectiveness of supervision in achieving the benchmark. These criteria are not a checklist but they are used as pointers/references to make sure the benchmarks are graded based on tangible elements.

The following table summarises the outcome of the benchmarking:

	ECB	GR	LI	PL	SI	SE
1. EBA Guidelines are fully implemented	FA	FA	LA	LA	FA	LA
2. The procedure for submission of the application is effective	FA	FA	FA	FA	FA	FA
3. The assessment for checking the compliance of the implementation of the DoD is effective	LA	LA	LA	LA	LA	PA

Legend:

Fully applied: all assessment criteria are met without significant deficiencies	FA
Largely applied: some of the assessment criteria are met with some deficiencies, which do not raise any concerns about the overall effectiveness of the competent authority, and no material risks are left unaddressed	LA
Partially applied: some of the assessment criteria are met with deficiencies affecting the overall effectiveness of the competent authority, resulting in a situation where some material risks are left unaddressed	PA
Not applied: the assessment criteria are not met at all or to an important degree, resulting in a significant deficiency in the application of the provision(s)	NA

2. Background information

2.1 Supervisory interactions / supervisory set-ups

To put the analysis outlined below into context, it is important to look at the different possible supervisory set-ups in the respective Member States.

For euro area / banking union Member States within the Single Supervisory Mechanism (SSM), there are:

- significant institutions (SIs) under direct ECB/SSM supervision;
- less significant institutions (LSIs) supervised by national supervisors, in close cooperation with the ECB.

For non-SSM countries, the national supervisor is in charge of the supervision, although there might be subsidiaries of their local institutions under direct supervision of the SSM and consequently cooperation between supervisors is necessary. Conversely, a parent company from an SSM Member State can have subsidiaries supervised by national supervisors in a non-SSM Member State.

These different organisational set-ups were taken into account by the Peer Review Committee (PRC) when assessing the application of the definition of default by the targeted CAs. In particular, they were taken into account when checking if the application of the DoD GLs has been executed in a homogenous way – especially for IRBA banks for which the ECB/SSM has had the lead and developed specific guidance, in comparison to non-SSM CAs.

The next section comprises a brief overview of the specific national home-host arrangements as well as banking sector specificities where deemed necessary, as these will provide context and facilitate the interpretation of some results further down the line.

2.2 Specific CA observations and characteristics

European Central Bank (ECB)

For IRBA institutions within the SSM (with exclusively SSM subsidiaries), the home NCA of the institution is also involved in the assessment of changes to the definition of default either as a member of the joint supervisory team (JST) or as a member of the assessment team (AT) in the context of on-site inspections.

In addition to the above, for IRBA institutions which are subsidiaries in a non-SSM country, the corresponding non-SSM CA is also involved in the assessment in coordination with the JST. In this context, the process of issuing a supervisory decision is commonly referred to as the 'joint decision process'. Two cases of supervisory cooperation with non-SSM countries may occur:

- When the ECB is the consolidating (home) CA, on(off)-site activities in non-SSM countries are agreed upon with the local (host) CA, and they can be performed either by an SSM or mixed SSM/local AT following the SSM process, or by a local team following their own processes. Moreover, in this case, the ECB is responsible for issuing the joint decision following an internal model investigation (IMI).
- When the ECB is a host supervisor, it confirms to the home CA the completeness of the application package and contributes to the assessment. On-site activities in non-SSM countries are agreed upon with the home CA and performed by either a local AT, or an SSM or mixed SSM/local team. In this instance, the home CA is responsible for issuing the joint decision in close cooperation with the ECB.

In addition, for IRBA institutions with non-EU subsidiaries, on-site activities in the non-EU subsidiary can be performed either by an SSM or mixed SSM/local AT following the SSM process, or by a local team if an equivalent supervisory standard is ensured. The non-EU CAs conduct on-site activities as agreed within memoranda of understanding and share all information from the ongoing review. The assessment report is shared with non-EU CAs upon consent of all involved EU authorities.

Greece (GR)

All Greek LSIs use the standardised approach (SA) to calculate their capital needs against credit risk. As the host supervisor, GR collaborated with the ECB. In this context, differences in the supervisory treatment between IRBA and SA banks are observed which are not specific to the different supervisory practices between the ECB and GR but rather due to the different processes for assessing changes to the definition of default for IRBA and SA institutions. For example, IRBA banks were subject to on-site inspections and, where underestimation of risk was identified, capital-

related limitations. However, SA banks were not subject to holistic DoD-related inspections, given that certain elements of the DoD were assessed on an ad hoc basis as part of broader-scope credit risk inspections.

Liechtenstein (LI)

With regard to the legislative situation, LI is a European Economic Area (EEA) country, so not all EBA Guidelines are transposed into national law. The CRR has nonetheless been included in the EEA agreement and EEA countries are expected to comply with the CRR as well as EBA GLs, and LI expects full compliance by the CIs under its supervision.

The LI banking industry counts 11 banks which only apply the SA. The sector is rather small (total credit exposure approximately CHF 30bn) and concentrated: over 90% of the consolidated balance sheet belongs to three O-SIIs. The country's banking industry is comparatively distinct in the sense that the business model of LI banks primarily focuses on private banking and wealth management (PB&WM) services, which are the most important source of earnings for the banking sector. The banks concentrate on two main credit types: mortgage and Lombard¹ credit. Commercial loans do not make up significant proportions of the loan portfolio of Liechtenstein banks. The nature of the banking industry in LI makes typical DoD items, especially the 90 DpD criterion, less relevant.

As LI is not part of the SSM, there is no regular interaction with the ECB. LI has interactions with especially the German and Austrian CAs as well as the Swiss authorities.

Poland (PL)

For one IRBA bank, PL is the home supervisor. In this context, ECB best practices were used for the on-site investigation and off-site analyses. For example, PL developed checklists based among other elements on ECB supervisory expectations, followed an approach similar to the ECB's holistic DoD project², and made use of the same validation staff involved in the on-site investigations for the IRBA banks under ECB supervision. A consistent supervisory approach was therefore applied across all Polish IRBA banks.

Slovenia (SI)

There are 13 banks in total in the SI banking industry: 7 SIs which are under ECB supervision (4 of them are subsidiaries of foreign banks), and 5 LSIs and 1 development bank which are under Bank of Slovenia (BSI) supervision. Only two banks (subsidiaries of foreign banks) apply the IRBA but for a small part of the credit portfolio. BSI only supervises banks that apply the SA. Banks that apply the IRBA are under the supervision of the ECB.

¹ Lending secured by liquid assets from an investment portfolio. Lombard lending bears limited credit risk leading to economic losses, due to typical over-collateralisation and conservative haircuts. Margining processes, however, do carry operational risk.

² DoD-related projects that the ECB has undertaken as outlined on page 19 of the report. These are the 2017 project 'Implementation of the new DoD within the SSM for institutions using the IRBA', the 2018 'two-step approach' supervisory strategy and the '2020 edition of the DoD Project' (DoD2020).

SI does not actively collaborate with other CAs on the application of the DoD. In general, local regulations are binding for banks and savings banks that are established in Slovenia, have a Slovenian banking licence and are under BSI supervision. However, banks and branches of foreign banks that are under the supervision of the ECB are not subject to local legislation. In order to ensure a level playing field for LSIs and SIs established in Slovenia, SI ensures wherever possible full alignment with the ECB on the application of GLs and hence also DoD.

Sweden (SE)

SE served as the home supervisor for three of the largest Swedish banks and as the host supervisor for two IRBA banks during the reference period. As the home supervisor, SE collaborated with other Nordic supervisors (DK, FI, NO) and the ECB. While the ECB conducted the IMI (Internal Model Investigation) for assessing the definition of default, the collaboration with the Nordic supervisors was not formalised, with the Nordic supervisors mainly providing comments on the Swedish authority's assessment. In both cases, however, as both host and home supervisor, the joint decisions incorporated the findings of both the home and host supervisors.

It is important to underline that SE as home supervisor follows the same process for joint decisions irrespective of whether the host supervisors are the ECB or Nordic supervisors. However, host supervisors have different assessment methods.

3. Implementation of EBA/GL/2016/07

3.1 Introduction

This chapter analyses the implementation of EBA/GL/2016/07 based on the following benchmarking criteria:

- whether the CA has fully implemented EBA/GL/2016/07 (criterion 1);
- whether all elements of the GLs are integrated into CA practices (e.g. by amending their legal framework or their supervisory practices) (criterion 2).

3.2 Transposition of EBA/GL/2016/07

European Central Bank (ECB)

The ECB has fully implemented the EBA GLs on DoD through a mix of binding and non-binding regulatory provisions. The ECB notified the EBA on its full compliance with the EBA GLs on DoD by 1 January 2021.

Greece (GR)

In GR, the EBA GLs on DoD have been integrated within a binding regulatory framework for all the Greek institutions via the Executive Committee Act 181/28.01.2021 of the Bank of Greece (BoG), which also incorporates the BoG's framework for national discretion on the materiality threshold of a credit obligation past due (Commission Delegated Regulation (EU) 2018/171).

Liechtenstein (LI)

LI fully implemented the GLs and expects compliance from the institutions under the supervision of the LI authority (FMA). When implementing GLs, LI compares the existing regulatory framework (Liechtenstein Banking Ordinance, BankV) with the GLs in question. On transposition, LI operates in a 'principles-based' and risk-oriented fashion, meaning that it is not always necessary to transpose every aspect of GLs into national law, which is the case for / has happened with the DoD GLs. Before declaring compliance, LI assesses whether there are legal or practical impediments which might hinder the applicability of the GLs.

Poland (PL)

In PL, the EBA GLs on DoD have been implemented through binding and non-binding regulatory provisions in the national legislative framework. When conducting its supervisory activities, PL is obliged to take into account the guidelines and recommendations of the EBA. Moreover, supervised institutions in PL are obliged to comply with the requirements arising from legal provisions and take into account supervisory prudential recommendations issued by the relevant supervisory authorities, in particular the PFSA and the EBA.

Slovenia (SI)

SI decides on the application of EBA GLs in the form of a Regulation, which is secondary national legislation on the basis of Article 13 of the Slovenian Banking Act. The DoD GLs were fully transposed into national legislation.

The Regulation on the application of the DoD GLs was issued and published in the Official Gazette of the Republic of Slovenia as No. 75/13 on 23 December 2017, and were applicable as of 31 December 2020, in line with the latest date for application of the materiality threshold for credit obligations past due.

Sweden (SE)

SE has fully implemented the DoD GLs and expects both institutions under its supervision which apply the SA and institutions applying the IRBA to adhere fully to these GLs.

3.3 Implementation of the GLs via additional national legislation and/or supervisory practices or via CA guidance

European Central Bank (ECB)

A section dedicated to the DoD was included in the Credit Risk Chapter of the second release of the ECB Guide to Internal Models (EGIM), which was published on the ECB Banking Supervision website on 19 February 2024 (non-binding regulatory provisions). This provides additional guidance and transparency on how the ECB understands the rules on the DoD set out in EBA/GL/2016/07, and clarifies how the ECB intends to apply them and assess whether institutions meet these requirements.

Additionally, the ECB has sought to harmonise supervisory practices and ensure consistent application of the definition of default through the publication of the Guideline on definition of default for banks directly supervised by national supervisors (Guideline (EU) 2020/978 of the European Central Bank).

Greece (GR)

In addition to the implementation of the EBA GLs on the DoD, Executive Committee Act 181/28.01.2021 covers the GR framework for national discretion on the materiality threshold of a credit obligation past due.

In order to get an initial overview, in May 2019 GR launched a consultation process regarding the adoption of EBA/GL/2016/07 with the Association of Greek Banks and the Cooperative Banks Association and in July 2020 sent an SAQ to Greek LSIs to verify their compliance with the main areas of EBA/GL/2016/07 (i.e. past due criterion, materiality threshold, UTP indications, criteria to return to non-defaulted status, application of the DoD to retail exposures, etc.). For the cases of non-compliance LSIs were requested to provide an implementation action plan for those specific areas. LSIs were also requested to provide relevant documentation such as internal policies and/or risk management procedures.

In addition to transposing the GLs, GR specified certain further provisions in the Executive Committee Act mentioned above, among others:

- Counting days past due, noting that the institution should have the appropriate systems for monitoring and calculating the days of delay, and clarifying the cases in which the counting of the days of delay is suspended. The analysis of the factors for exercising the option of suspension (as defined in paragraphs 17 and 18), as well as the evaluation of the indications of possible inability to pay, are expected to be taken into account in the estimation methodology for the expected credit loss.

- Distressed restructuring, requiring banks to achieve effective monitoring of the distressed restructuring in order to have a distinct field in their information system. Also requiring that forbearance measures should be defined in the respective policies of the institution.
- On other indications of unlikelihood, to pay a reference to the EBA GLs on connected clients (EBA/GL/2017/15) was added with a view to identifying relationships within groups of connected clients.

Liechtenstein (LI)

There is no additional guidance from LI. It is worth noting that the Banking Ordinance sets the requirement on what is considered to be an impaired loan according to local GAAP. This is based on the IFRS definition of 'credit impaired', which is assumed to be in alignment with the regulatory definition of default. In case of misalignment LI classifies 'default' based on the prudence principle. The link between the LI Banking Ordinance, accounting standards and corresponding annual audit cycles is important to ensure compliance with the CRR and GLs. When necessary, other publicly available methodologies (e.g. ECB guidance, although LI is not within the SSM) are used for interpretation.

Poland (PL)

In accordance with CDR (EU) 2018/171, PL has implemented one single threshold for the assessment of the materiality of a credit obligation as outlined in Article 178(1)(b) of Regulation (EU) No 575/2013. The Polish regulation of the Minister of Finance, Investment and Development of October 3, 2019 on the materiality level of an overdue credit obligation specifies, among other things, uniform materiality thresholds in local currency equivalent.

Sweden (SE)

SE did not consider it necessary to issue any additional general guidelines beyond the EBA GLs, since guidelines from the ESAs addressed to CAs are considered equivalent to Swedish general guidelines.

SE communicated on its website³ that the GLs are binding and that banks under its supervision should follow them. In particular, SE notified the EBA of its intention to comply with the GLs as well as that the GLs apply to institutions using either the SA or IRBA for calculating the capital requirement for credit risk. Further, SE has updated the regulation regarding prudential requirements and capital buffers to define materiality thresholds in the SEK currency used in Sweden.

Slovenia (SI)

SI informed institutions on changes or amendments in law (regulations) that impact the DoD using its website and letters on several occasions. For instance, in 2018 SI informed the institutions using

³ SE complies with EU guidelines on the application of the definition of default | Financial Supervisory Authority.

a letter on the definition of the threshold for assessment of the materiality of a credit obligation past due for the purpose of the definition of default. Besides changes to the materiality threshold, SI also alerted banks to the upcoming GLs on the DoD definition and indicators of UTP specifically. Another example of active communication are the letters relating to CRR Quick Fix (EBA/GL/2020/11). Finally, SI ensures regular communication with the Slovenian Banking Association, which regularly presents new regulations and corresponding challenges in banking industry meetings. SI supervisors also make use of the SSM Operational Guidance⁴.

3.4 Assessment of benchmark 1 – Level of implementation of EBA Guidelines

Based on the elements outlined in sections 3.2 and 3.3 the PRC estimated that three CAs (ECB, GR and SI) should be rated **'fully applied'** on benchmark 1, fulfilling both criteria. The GLs have been duly implemented and additional guidance to credit institutions was provided.

LI, PL and SE were rated **'largely applied'** by the PRC.

Although LI is applying large parts of the GLs, these have not been explicitly transposed into national law in their entirety (criterion 1). Furthermore, while the supervisory expectation is that credit institutions comply with EBA GLs and this is communicated as such to CIs, LI did not provide any additional guidance to banks (criterion 2). Based on the above, but also taking into account LI's specific EEA status as well as the specificity of its banking sector and other rules applied, the PRC rates LI on benchmark 1 as overall **'largely applied'**.

For PL and SE, while the GLs have been duly implemented into the national legislative framework (criterion 1), the additional guidance provided to credit institutions (criterion 2) is limited to the RTS on materiality thresholds which apply directly in any case. Consequently, the PRC deemed a rating of **'largely applied'** adequate for PL and SE.

	ECB	GR	LI	PL	SI	SE
Criterion 1	FA	FA	LA	FA	FA	FA
Criterion 2	FA	FA	PA	PA	FA	PA
Overall score for benchmark 1	FA	FA	LA	LA	FA	LA

3.5 Conclusions / findings / best practices

Overall, it can be concluded that benchmark 1 has been duly implemented by most CAs, but with different approaches to the implementation.

⁴ SSM Operational Guidance 3 On-Site Inspections, Annex A Credit Risk and Counterparty Risk (Chapter A13).

In terms of **additional findings**, the following should be noted:

- Most CAs (GR, LI, PL, SI) noted that they did not encounter any major practical, organisational or other types of challenges in implementing the DoD GLs.
- Nonetheless, one challenge raised by the ECB with the implementation of the so-called 'new DoD' resulting from EBA/GL/2016/07 was related to the high number of IRBA applications received for significant institutions (approximately 65) for which the ECB had to assess compliance with the GLs given that, under the IRBA, any change to the DoD is considered a material model change (COM Delegated Regulation 529/2014).
- For SI, a key finding was that banks apply the threshold for assessing the materiality of credit obligations past due differently, but the overall impact on NPEs in the banking system was limited.

In terms of **best practices** (additional guidance, upfront studies / impact assessments, communication), the following should be noted:

- GR and the ECB provided detailed additional guidance. Both CAs successfully identified the areas in the GLs where uncertainties were probable, and proactively anticipated these. The ECB also provided guidance through supervisory guides, which offered transparency on how the ECB interprets these rules and their intended application when assessing whether institutions meet these requirements. In this regard, it is worth mentioning the ECB Guide to Internal Models, where there is an entire section dedicated to the definition of default within the credit risk chapter, clarifying supervisory expectations for IRBA institutions.
- SI provided the information that banks in general are expected to monitor published regulations and be up to date on upcoming regulations and GLs, using all the tools at their disposal for active communication. In addition, SI communicated upfront, asking LSIs for an impact analysis of the new materiality thresholds on the amount of defaulted exposures (NPEs) and loan loss provisions. This exercise helped the institutions in preparing for the implementation of the new DoD and the CA in making an appropriate decision regarding the implementation of the relative threshold. Next to the impact analysis, SI has had two meetings with the Slovenian Banking Association on the implementation of the DoD GLs.
- LI follows/ followed a similar approach. When implementing GLs, LI compares the existing regulatory framework (Liechtenstein Banking Ordinance, BankV) with the GLs in question, identifies the aspects that are already in place, and, where it is deemed necessary, changes or updates local laws and regulations. Complementarily, the Liechtenstein Bankers Association (LBA) also queries banks, especially on implementation difficulties or obstacles, which is actively taken into account by LI.

- Throughout the whole duration of the ‘DoD Project’⁵, the ECB deemed it key to ensure regular internal communication, including inter alia several directorates within the ECB, JSTs and line supervision, as well as horizontal functions and external communication with industry associations.

4. Procedure for submitting an application for changes in the definition of default

4.1 Introduction

This chapter analyses the implementation of EBA/GL/2016/07 based on the following two benchmarking criteria:

- there is a procedure in place for submission of an application for changes in the DoD (criterion 1); and
- that procedure is clearly specified and duly documented by the respective CA (criterion 2).

Against this background, the chapter also examines the CA’s role in interacting with banks under its supervision to facilitate/encourage potential applicants.

The chapter distinguishes between banks using the IRBA for calculating capital requirements for credit risk and those applying the SA, noting that the procedure for submitting an application and the following approval procedure have a legal basis only for IRBA banks, set out in COM Delegated Regulation 529/2014. Consequently, the second criterion only applies to the ECB (MS in which IRBA banks are solely under the supervision of the ECB) and/or NCAs which have local IRBA banks in their MS. A CA that does not have an IRBA bank within its supervisory remit cannot be asked to fulfil this second criterion and will hence not be mentioned in section 4.3.

4.2 Procedure for submission of an application in place

European Central Bank (ECB)

Procedures for submitting an application for approval of changes in the DoD have to be distinguished between SA and IRBA banks.

Regarding SA banks, given that the regulation does not require a specific application/approval procedure, the implementation of the DoD was covered by the ECB via the annual SREP and/or OSIs as well as ad hoc targeted reviews following a risk-based supervision approach.

⁵ The ‘DoD Project’ is further described in section 4.2.

As far as the IRBA banks are concerned, to coordinate the first implementation of the new DoD, the ECB in 2017 launched the project 'Implementation of the new DoD within the SSM for institutions using the IRBA' ('DoD Project') with the objective of structuring the application process linked to the new DoD. As part of this initiative, a preferred supervisory strategy was launched in 2018: the 'two-step approach' (2SA hereinafter), involving two sequential steps: first, the implementation of the new DoD without a concurrent adjustment to the existing IRBA models; and, second, (once a minimum amount of real-time data based on the new DoD had been collected) the adjustment of the models to consider the new DoD and other regulatory evolutions. IRBA institutions were invited (not obliged) to take part in the 2SA.

For IRBA institutions that opted not to adhere to the 2SA, or only did so for part of their IRBA portfolios, simply amending processes, procedures and IT systems used for default detection without adjusting the resulting risk estimates was not a feasible way forward. In this context, to coordinate the first implementation of the new DoD for these institutions too, the '2020 edition of the DoD Project' (DoD2020) was set up.

Regarding ongoing model changes linked to the DoD, no dedicated process was foreseen, and institutions were expected to follow the guidance provided for submitting applications to the ECB that relate to internal models.

Greece (GR)

In GR, only the significant institutions (SIs) apply the IRBA, all falling under the supervision of the ECB. Therefore, material model changes related to the DoD implementation have been / are covered by the formal procedure of the ECB. All Greek LSIs apply the SA, for which there is no formal procedure. GR applies its ongoing supervisory framework to monitor changes in the DoD. In any case, for the LSIs, the 'new DoD' was verified within the context of the SREP and complemented by a self-assessment questionnaire sent to the banks, serving as the basis for a horizontal review across LSIs in 2021, covering the main areas of the DoD. A follow-up to this exercise was conducted in 2022. Banks were asked to submit a specific timeline for their compliance in specific areas.

Liechtenstein (LI)

LI did not have any IRBA banks during the reference period of this peer review. LI received one general application for a banking licence in recent years but no DoD applications. If banks were to apply for the IRBA, the FMA would be informed sufficiently in advance. Compliance with [EBA/GL/2016/07](#) is verified using financial/regulatory audits, OSIs and regular supervision.

Poland (PL)

In PL, a formal submission procedure for changes in the DoD is in place for IRBA banks. In accordance with CDR (EU) No 529/2014, changes to the DoD are considered material model changes. Therefore, these changes need to be notified and assessed by CAs. For SA banks no formal procedure is in place. PL verified the DoD within on-site examinations of credit risk in those SA

banks that were covered and applies its ongoing supervisory framework to monitor changes in the DoD (e.g. via the annual SREP).

Slovenia (SI)

There are no IRBA banks under direct SI supervision, only under joint supervision with the ECB. SI did not receive applications from SA institutions, nor did SI mention any formal procedures to verify compliance, other than via off-site supervision, the SREP and credit risk OSIs.

Sweden (SE)

SE followed an order of prioritisation, dividing the banks into four categories based on their relevance. IRBA banks had to apply for authorisation in any case, during which a completeness check was performed. If that check was not passed, the application was automatically rejected. In total, SE had 16 applications. For the most relevant SA banks (12), compliance was verified through an SAQ.

4.3 Documentation of procedure for submitting the application

For this part, only CAs with IRBA banks are in scope given that the submission of applications is only relevant for IRBA banks as per the applicable regulation.

European Central Bank (ECB)

Regarding ongoing model changes, there is a well-documented procedure in place where institutions are expected to follow the guidance for submitting applications to the ECB that relate to changes to internal models, which are explained on the ECB Banking Supervision website⁶. This procedure is applicable also to changes linked to the DoD.

Greece (GR)

IRBA banks follow a well-documented procedure given the regulatory requirements for the notification and supervisory assessment of material model changes in the context of the DoD. Given that all IRBA banks in Greece are considered significant and fall under the supervision of the ECB, these banks have been subject to the SSM's 2SA.

Liechtenstein (LI)

LI did not receive any applications for the IRBA and does not have any IRBA banks.

Poland (PL)

IRBA banks follow a well-documented procedure given the regulatory requirements for the notification and supervisory assessment of material model changes. In this regard, IRBA banks

⁶ https://www.bankingsupervision.europa.eu/banking/tasks/internal_models/imi/html/index.en.html

under the joint supervision of the ECB and PL have been subject to the SSM's 2SA. In addition, one less significant IRBA bank under the sole supervision of PL submitted an application in 2020 for initial model application. The process and assessment standards followed for the local IRBA bank were generally in alignment with the SSM.

Slovenia (SI)

SI did not receive any applications for the IRBA as these are handled by the ECB.

Sweden (SE)

SE does not have a formal pre-application process. The authorisation process includes a completeness check phase. However, SE chooses a communicative approach to inform banks about the EBA's published guidelines and technical standards. Moreover, it is important to remember that for IRBA banks there is documentation related to material model changes for changes in the DoD.

4.4 Assessment of benchmark 2

Benchmark 2 focuses on the procedures established by the CAs for submitting an application for changes in the definition of default concerning IRBA banks. In this regard, as described at the beginning of the chapter, the procedure for submitting an application and the subsequent approval procedure have a legal basis only for IRBA banks, set out in COM Delegated Regulation 529/2014. Given that the GLs do not set out specific requirements for the SA in this context, the latter could not be considered for the purpose of the two criteria for this benchmark.

For the purpose of the assessment of this benchmark, the following assessment criteria were set:

- use of a structured approach regarding the procedure for submitting the application for IRBA banks: implementing clear and structured approaches facilitates compliance by offering a phased methodology and clear milestones for IRBA institutions to adopt new DoD requirements;
- documentation and regulatory clarity regarding the procedure for submitting the application for IRBA banks: establishing a well-documented procedure, rooted in regulatory standards, ensures transparency and provides clear guidelines for IRBA banks to follow when submitting applications related to the implementation of the 'new DoD'.

Taking into account all of the criteria, the PRC found that all six CAs can be rated '**fully applied**' for both criteria.

	ECB	GR	LI*	PL	SI	SE
Criterion 1	FA	FA	FA	FA	FA	FA
Criterion 2	FA	FA	NA*	FA	FA	FA

	ECB	GR	LI*	PL	SI	SE
Overall score for benchmark 2	FA	FA	FA	FA	FA	FA

*LI is rated 'not applied' here as there are no IRBA banks in LI.

4.5 Conclusions / findings / best practices

Based on the examination of the different procedures for submitting applications for changes in the DoD across different MSs and the CAs targeted for this peer review, a first distinction emerges between the SA and the IRBA banks. While for IRBA banks implementing (changes to) the DoD requires a change request needing prior approval in accordance with Article 143(3) of EU Regulation 575/2013 (CRR) and Regulation (EU) 529/2014, for SA banks there is no such requirement for an application/approval procedure in the case of changing the DoD.

As for SA banks no formal application process is required for permission for changes to the DoD, it becomes crucial that the implementation of the DoD is covered through interaction between the CAs and the supervised banks to provide guidance initially and to ensure proper implementation thereafter.

In terms of **best practices**, regarding the procedure for submitting the application, the process implemented by the ECB known as the 'two-step approach' (2SA) emerges as a best practice, as it has substantially facilitated the application process for IRBA banks (described in section 4.2) and provided a structured path to achieve compliance with the new DoD for those IRBA bank that chose to follow it. As part of this 2SA, a dedicated FAQ process was also established, where institutions submitted a total of 95 questions. This stands out as an example of supervisory guidance and clarity, addressing not only the clarification of supervisory expectations on regulatory requirements but also specific operational aspects related to implementation.

5. Effective compliance with / implementation of the DoD

5.1 Introduction

This chapter examines the following benchmarking criteria with regard to the assessment of the DoD per se as well as the assessment of the GLs on the application of the DoD, i.e. whether:

- there is a framework methodology in place (criterion 1);
- the assessment framework is clearly specified and duly documented (criterion 2);

- the CA's assessment framework checks that institutions have adopted the DoD across: a) their systems and processes, b) internal models, c) internal policies (criterion 3);
- in the case of non-compliance, an adequate remediation plan has been adopted (criterion 4);
- the assessment framework has covered all aspects of the GLs on the definition of default, also taking into account (only where necessary) proportionality considerations pertaining to the complexity of the supervised institution (criterion 5).

5.2 Assessment of frameworks (criteria 1, 2 and 3)

European Central Bank (ECB)

For the banks using the SA, the ECB relies on the annual SREP and coordinated horizontal reviews (e.g. UTP deep dives) based on internal guidance. Regarding the UTP deep dives, the assessment is done through a review of banks' own policies, their implementation in practice (walkthroughs) and the off-site review of selected credit files. The off-site credit file reviews aim to assess the practical implementation of the review and UTP classification process and its adequacy, while walkthroughs aim to understand how the identification, approval and monitoring processes work in practice (and if this implementation aligns with policies and regulations) and how decisions are documented.

The ECB starts (for all SIs under its supervision) with identifying and assessing key risks and vulnerabilities that affect supervised entities under its remit, forming the basis for the definition of supervisory priorities and feeding into the planning of the regular supervisory activities, which are laid down in the Supervisory Evaluation Programme (SEP). The SEP covers the tasks and activities related to ongoing supervision and on-site missions, considering available resources. For significant institutions (SIs), these tasks fall under the remit of the joint supervisory teams (JSTs), supported by inspection teams for on-site missions working in close cooperation with the respective JST. The various supervisory activities typically result in supervisory measures addressed to the supervised entity. Supervisory activities and decisions are typically followed by a number of routine steps such as the monitoring of compliance and, if necessary, enforcement and sanctions.

In terms of inspections, a distinction is drawn between on-site inspections (OSIs), which are in-depth investigations of risks, risk controls and governance (including IFRS 9 models and framework), and internal model investigations (IMIs), which are in-depth assessments of internal models used for the calculation of own funds requirements, in particular with regard to methodologies, economic appropriateness, risks, risk controls and governance. Both types of inspection are carried out on the basis of a predefined scope, timeline and set of resources. They are performed mostly on site: only IMIs of lower complexity may be performed fully off site by an inspection team or, in some cases, directly by JSTs. The outcome of an inspection is an assessment report detailing the findings. The assessment methodology for OSIs and IMIs is documented, it covers all risks and topics in scope of inspections, and it is regularly updated on the basis of regulatory developments, observed best practices and new emerging risks.

Greece (GR)

For SA banks, GR performed the assessment of the DoD mainly via two horizontal reviews, in its ongoing supervisory activities in the context of the SREP, and as part of on-site investigations. A first horizontal review was conducted across LSIs in 2021 using SAQs, in which confirmation of compliance with the main areas of the DoD (i.e. past due criterion, materiality threshold, UTP indications, criteria to return to non-defaulted status, application of the DoD to retail exposures, etc.) was checked (and remediation plans established for cases of non-compliance). In 2022, a follow-up SAQ was sent to Greek LSIs. The outcome was assessed in the context of the SREP and communicated to the LSIs with the SREP decisions. Moreover, the analysis served as an input for the SEP for on-site inspections.

As part of ongoing supervision, GR also monitors adherence to the DoD by reviewing AnaCredit data (i.e. granular instrument level data), where, for example, the default identification and classification for specific borrowers is challenged. In particular, the AnaCredit tool has been used to identify cases where exposures to the same creditors have been treated inconsistently across different institutions in order to assess the consistent implementation of the EBA DoD across the LSI sector. With respect to the on-site investigations, no holistic approach has been taken regarding reviewing DoD implementation, but certain elements of the DoD have been part of broader-scope credit risk missions.

For IRBA banks, DoD compliance has been reviewed as part of on-site investigations triggered by the material model changes. As all Greek IRBA banks are under ECB supervision, the SSM two-step approach applied.

GR has also added several elements / guidance to banks when implementing the GLs, outlined in section 3.3 above. Given that GR verifies these elements, these can partly be considered additional frameworks.

Liechtenstein (LI)

Due to the nature of the banking industry, no initial assessment on DoD was performed by LI.

In LI there are three types of inspections used to assess compliance with regulatory requirements: annual financial audits, annual regulatory audits and OSIs. The 'audits' are performed on an annual basis by external audit firms, whereas OSIs are the responsibility of the CA. Besides OSIs, LI carries out questionnaires such as annual ICAAP/ILAAP or risk-specific questionnaires to identify supervisory focus areas and selected deep dives. The financial audit covers the financial impairment process, which includes correctly classifying assets into the impairment categories. The basis of this audit is the LI Banking Ordinance which codifies the local accounting rules. The regulatory audit is comparable to a SREP process but is complementary and not a substitution of it – it covers topics such as credit risk management or ICAAP. For this audit, an annual audit plan needs to be signed off by the FMA. Selection of specific audit fields is done using a risk-based approach. The basis of

the regulatory audit is the requirements of the applicable LI banking law. GLs are used for interpretations.

LI assesses compliance with regulatory requirements during regular OSIs, mainly at the large O-SIIs. Typically, the FMA does two or three OSIs per year, depending on supervisory priorities. For smaller bank OSIs, LI FMA applies proportionality where feasible and necessary (e.g. smaller private banks only offering Lombard loans to selected wealthy clients are scrutinised differently by the FMA). The OSIs focus on overarching topics such as credit risk, not the DoD specifically.

During 2021-2022, LI conducted credit risk OSIs at the three O-SIIs, focusing on loan originations as well as recovery and work-out. The OSIs included the evaluation on impairment and implicitly on the DoD. With this exercise, LI captured ~94% of all LI credit exposure. The FMA used both quantitative data and qualitative information. Quantitative input is regular FINREP/COREP, but also other data (FINREP LOCAL and FINREP IFRS for the OSIs) covering additional information such as repayment schedules and LtVs. Furthermore, LI reviews credit files, as well as the consistency of internal policies, procedures and working instructions. When certain risks are identified and it is deemed necessary by the FMA, deep dives or ad hoc investigations can be initiated. The FMA also conducted a market-wide questionnaire on loan origination, monitoring and work-out for which loan tape information at facility level was collected for the entire banking industry excluding the three O-SIIs.

Poland (PL)

For SA banks, assessment of the DoD is mainly covered by ongoing supervision as well as on-site investigations performed on the basis of the outcome of the SREP. As part of the SREP, DoD compliance is assessed on the basis of an SAQ from the supervised entities. If the SAQs in combination with the reporting from the banks' internal audit or validation functions point towards deficiencies, then PL could decide to include certain aspects of the DoD in the scope of on-site inspections.

SA banks in PL comprise approximately 20 commercial banks and 500 plus cooperative banks. Between 2021 and 2022, 75 inspections were performed, of which 18 inspections in commercial banks and 57 in cooperative banks. Though these inspections did not target the DoD holistically, some elements of the DoD were reviewed as part of a broader credit risk scope. In addition, no ad hoc horizontal analysis was performed across SA banks to assess DoD compliance.

For IRBA banks, DoD compliance has been reviewed as part of on-site investigations triggered by the material model changes. For the four IRBA banks under ECB supervision, the SSM two-step approach was applied. Regarding the local IRBA bank, this concerned an initial model approval and was therefore subject to a broader on-site investigation, where the DoD was part of the scope.

Slovenia (SI)

For the assessment of the application of the DoD at the banks under its supervision (only SA), SI relies primarily on OSIs, the annual SREP process and ongoing supervision. SI hence uses a risk-based approach to decide which banks to target for specific or individual on-site examination.

OSIs

Various OSIs were carried out covering the DoD, but SI did not perform DoD-specific OSIs so far. The DoD is a topic of investigation in both credit risk and IFRS 9 OSIs (or combined). The DoD examinations are always part of larger exercises with a larger scope, such as a thematic or individual review of the IFRS 9 standard. For one LSI, SI examined the DoD within a thematic review of IFRS 9 implementation (2020), including follow-up on site (2023). The implementation of the DoD GLs was also assessed in broader fashion in another thematic review (three LSIs) in 2023. Furthermore, SI conducted a special OSI covering credit risk / IFRS 9 at another LSI. There were no material findings in the various evaluations. No horizontal analyses or off-site investigations were done regarding the DoD application.

SI follows the ECB SSM Operational Guidance for the assessment of credit risk and the DoD in particular⁷, but proportionally adapts the guidance to fit LSIs that only apply the SA. The level of depth of OSIs depends on the scope of the relevant OSI (determined by ongoing supervision) and normally does not exceed ECB guidance.

Typically, SI splits the review of the DoD into two parts – a review of DpD and an assessment of UTP, which are equally time-consuming. The DpD review is technical in nature, it requires an evaluation of IT solutions behind the counting, but also the appropriateness of data is taken into account. UTP assessments are more qualitative in nature. This typically requires evaluation of the UTP triggers by bank employees (which relies on expert judgement), which is scrutinised by supervisors.

When conducting an OSI, typical evidence sought is internal policies/procedures, governance (roles, responsibilities, reporting), minutes of internal bodies, findings of internal audit, sample testing/calculations, extracts from internal IT applications, information from conducted interviews, reviews of past UTP assessments and the review of payment history (for DpD). Depending on the level of thoroughness of the OSI and institutions' profile, the starting point is interviews with staff on DpD (thresholds, number of DpD, methodology for counting, IT systems in use) and UTP (which triggers are used, what (external) information is used by the bank, differentiation between hard/soft triggers, process on determining default). This is followed by a walkthrough of the process and, if within scope, a deep dive on DpD counting and UTP triggers. On DpD, SI samples clients with DpD above 90 days without default classification. Evaluation then focuses on whether repayments were taken into account correctly, the source of repayment and impact on the DpD counter. For UTP reviews, SI reviews credit files and decision making on a sample of clients. SI typically selects for review clients with low (bad) ratings, or where restructuring has been done / has been ongoing

⁷ SSM Operational Guidance 3 On-Site Inspections, Annex A Credit Risk and Counterparty Risk (Chapter A13), A.13.3.3.11, 12, 13, 14, 15, 16, 18.

recently. Supervisors also evaluate UTP tests that were already performed to see if the bank is in line with its rules and policies.

SREP and ongoing supervision

Regarding the SREP and ongoing supervision, SI assesses the quality of the credit portfolio of individual banks, also by reviewing credit risk reports which typically provide information on defaults and identification of new defaults (e.g. DpD and UTP). By reviewing credit reports, SI can detect inconsistencies (for example, UTP criteria are met but the client is still classified as 'performing').

Sweden (SE)

SE has adopted a risk-based approach, devoting most of its resources to the largest institutions. This has resulted in a significantly different approach between IRBA banks and SA banks.

For IRBA banks, a memorandum was published in 2018 describing important areas where the regulation is being clarified and the Swedish authority's expectations on how banks should implement the methodology. Additionally, the authorisation process included a completeness check phase which if not passed automatically resulted in rejection. In particular, as part of the completeness check phase, SE model experts checked if the application contains the following technical and process documents:

- policies for the DoD, including all unlikelihood to pay criteria and corresponding criteria for cures, in accordance with EBA/GL/2016/07, sections 4 and 5;
- the bank's operationalisation of all unlikelihood to pay criteria and cures, e.g. in the credit processes at the first line of defence.

The inspections were conducted off site, except in a few cases.

Regarding IRBA banks, SE has adopted a proactive and communicative approach to adequately inform banks in advance about regulatory changes in the IRBA repair programme, including the GLs on the DoD.

Regarding the SA banks, the DoD was assessed by sending an SAQ to 12 SA banks (a subsample of the total SA Swedish banks).

Although approximately 90% of the exposure in Sweden is represented by IRBA banks, SA banks were not subject to any specific direct supervision. Compliance with the DoD was verified solely through a self-completed survey by the banks themselves. However, for some SA banks, during the SREP, certain elements such as NPL ratios, IFRS transitioning and forbearance indicators were analysed, which are directly or indirectly related to the definition of default.

5.3 Assessment of remediation plans

European Central Bank (ECB)

For IRBA banks, the ECB has granted permissions to change their DoD whenever the proposed changes were able to ensure broad compliance with EBA/GL/2016/07 and ECB/2018/26. In the first implementation of the new DoD, all the DoDs across the institutions assessed under ECB jurisdiction were found to be broadly compliant with the Guidelines. However, most of them were not fully compliant. In general, the observed incompliances spanned across all areas of EBA/GL/2016/07 and three areas of incompliance proved to be quite frequent among the assessed DoDs and common across different institutions:

- with respect to paragraphs 79-82 of EBA/GL/2016/07: several institutions applied the DoD on the basis of criteria that were not verified at group level and they did not provide a rigorous justification for not implementing such a group-wide view due to consumer protection legislation, banking secrecy or other legislation prohibiting the exchange of information on obligors across the legal entities of the group;
- with respect to paragraph 51 of EBA/GL/2016/07: several institutions did not consider any default trigger based on reductions in the net present value following a distressed restructuring, or they considered it but they adopted a threshold higher than 1% or they omitted the actual calculation of NPV reduction for subcategories of distressed restructurings;
- with respect to paragraph 67 of EBA/GL/2016/07: several institutions used external or pooled data for the purpose of estimation of risk parameters but did not verify the consistency between their DoD and the DoD underlying these external or pooled data.

Whenever incompliances were identified, these were formalised into findings and measures that institutions were requested to implement by deadlines indicated by the ECB. Institutions were also requested to set up a credible remediation plan to implement those measures on time. Deadlines were differentiated based on the foreseen remedial actions: changes to the DoD policy or establishment of analyses (e.g. monitoring of common obligors) were given deadlines up to six months, whereas extensive changes to IT infrastructures supporting the DoD (e.g. to adopt a group view in the calculation of default triggers) were given up to 18 months.

The ECB also identified numerous issues in various thematic reviews which led to implementation measures for SA banks.⁸

Greece (GR)

GR did not have to implement any remediation plans during the DoD implementation for IRBA banks (which in GR are under ECB supervision).

⁸ The above findings also hold for section 5.4 but are mentioned in section 5.3 for ease of reference.

Certain SA LSIs were, however, asked to address compliance weaknesses identified during thematic reviews via SAQs (looking at the content of risk templates, counting days past due, UTP triggers), with banks having to indicate whether they were compliant or not, and to explain the measures they planned to take or had taken to implement this. If not compliant, banks were required to specify a timeframe for compliance and provide justifications. Other issues were discovered via on-site inspections. These resulted in specific findings which were included in the SREP decisions, and remedial actions were monitored.

Cases identified included:

- reclassification of exposures in the case of UTP indications following an on-site inspection;
- revision of credit policy (the revised policy was submitted accompanied with the approval from the board of directors of the bank);
- need for upgrade of IT systems (monitored via quarterly reports submitted by the bank on the progress of the action plan agreed and confirmation of the completion of the upgrade of IT systems through a report from the internal audit function).

Generally corrective action / remediation plans are discussed with banks which then confirm in writing implementation of the remediation measures. All remediation plans were completed – the only issues encountered were implementation delays.

Poland (PL)

PL did not report on having had to implement any remediation plans for non-compliance with any aspects of the GLs during the implementation of the DoD. However, during the implementation of the DoD, when all IRBA banks were obliged to prepare their application packages under the two-step approach, one bank was not sufficiently prepared (its main deficiencies were lack of a DoD policy and insufficient operational readiness), so their application was rejected. The bank went through the one-step approach and currently achieves broad compliance with the DoD GLs.

Liechtenstein (LI)

The aim is to remedy any findings or deficiencies subsequently, and they are discussed during the regular SREP. If deemed necessary, LI can enforce remediation, e.g. via sanctions/fines, capital additions or dismissal of management. LI reported only one instance where an increase of the provisioning amount was necessary due to improper implementation of the UTP triggers.

Slovenia (SI)

Follow-up on deficiencies is part of regular supervision and thus done by line supervisors, who gather all reports regarding remediation of deficiencies. SI prepares a report which is checked by experts, and asks banks for clarifications/explanations if deemed necessary. When remediation is

deemed successful, SI issues a letter confirming that a bank complies with the GLs. This decision is adopted by SI's governing council.

SI did not have to implement any remediation plans during the DoD implementation for IRBA banks (which in SI are under ECB supervision). Examples where remediation measures had to be implemented in SI are:

- miscounting of the number of days past due was found for a number of retail clients;
- lack of appropriate exit criteria when a debtor has met all the conditions for recovery and transition from defaulted status.

Sweden (SE)

The initial applications from IRBA banks were divided into three waves. In the first two waves, if banks did not demonstrate full compliance their application was rejected. There were a few cases in the third wave where banks were not fully compliant, and therefore it was necessary to draft a remediation plan. The agreed remediation actions had a timeframe between 3 and 24 months. Examples of identified deficiencies that required remediation plans are the following: proof of IT implementation, indication and timeliness of UTP, return to non-defaulted status, treatment of connected clients and MoCs policy.

SE did not have to implement any remediation plans during the DoD implementation for SA banks.

5.4 Assessment on whether the CA's assessment covered all aspects of the Guidelines (including proportionality considerations)

Below the most important (and recurring) points with regard to the targeted CA's assessment frameworks will be further highlighted and analysed.

European Central Bank (ECB)

The main issues identified by the ECB were the following:

- forbearance:
 - distressed restructuring: NPV test not conducted for all forbearance measures (e.g. some types of modifications excluded or not flagged as forborne);
 - calculation on NPV loss in the case of subsequent forbearance measures – banks often do not use the effective interest rate of the original exposure when there are subsequent forbearance measures;

- UTP indicators:
 - indicators' thresholds and subsequent actions often not clearly defined; automatic indicators are limited to those in the CRR (sometimes without further elaboration); clear guidance is missing for the assessment of soft UTP indicators and sectoral/portfolio-specific indicators are often missing;
 - no effective monitoring process to assess the quality of the UTP framework (e.g. effectiveness of the UTP classification and exit from default), resulting in absence of review and update of policies.

The ECB launched deep dives on UTP in batches of 5 to 10 banks, looking at all aspects of the process (i.e. governance, assessment of repayment capacity, triggers, monitoring of the framework's effectiveness). Line supervisors collected credit files to be able to challenge the bank if triggers were not executed according to the UTP policies, as well as to check the entire process. These deep dives were followed up with workshops with the banks to raise questions and discuss any supervisory findings. The setting and conditions of implementation of default, including UTP indicators, are also thoroughly reviewed as part of the numerous credit risk on-site inspections carried out on a regular basis. The related findings give rise to remedial actions by the banks involved.

Finally, supervisors drafted operational acts reflecting the outcome of the deep dives including supervisory findings, many of which referred to the DoD GLs, and requests for remedial action.

Greece (GR)

GR identified the following issues when assessing compliance with the DoD:

- delays in IT implementation for DpD calculation;
- low level of initial compliance regarding the UTP framework: this was mainly identified due to the provisions related to i) potential insolvency in the context of bankruptcy, and ii) potential insolvency in the case of distressed restructuring.

In order to get an initial overview, GR launched a consultation process regarding the adoption of EBA/GL/2016/07 with the Association of Greek Banks and the Cooperative Banks Association in May 2019, and in July 2020 it sent an SAQ to Greek LSIs to verify their compliance with the main areas of EBA/GL/2016/07 (i.e. past due criterion, materiality threshold, UTP indications, criteria to return to non-defaulted status, application of DoD to retail exposures, etc.). For the cases of non-compliance LSIs were requested to provide an implementation action plan for those specific areas.

In April 2021, a horizontal analysis was concluded, after assessing the Greek LSIs' responses/SAQs regarding their degree of compliance with the requirements of the DoD GLs.

In July 2022, a follow-up SAQ was sent to Greek LSIs in order to update the status of their compliance, with the results/measures incorporated into the credit risk element of the SREP and

communicated to the LSIs alongside SREP decisions and letters. The results also served as input for the Supervisory Examination Programme for GR's on-site missions.

In parallel, GR communicated to Greek LSIs via its supervisory expectations that the ICAAP report (for the purposes of the 2021 SREP) should include an impact assessment of the DoD implementation.

Liechtenstein (LI)

For LI, the following were the two most important elements uncovered while assessing compliance with the DoD:

- Past due criterion in the identification of default: due to the typical margining process in Lombard lending, LI noted that it is almost impossible to hit the 90 DpD trigger. This does not mean, however, that for the part of regular consumer mortgages or credit in LI banks this trigger cannot be reached.
- Indications of UTP: key deficiencies for this topic were not describing UTP in a sufficient level of detail, and/or not properly documenting distressed restructuring. LI also focuses on UTP triggers that specifically fit the LI banking industry.

On a more general note, LI reports an adequate 'margining' process to be one of the key 'default' risk in LI, as the major risk factor behind Lombard lending is the execution of collateral margining and corresponding close-out processes. LI considers this rather as an operational risk than a credit risk.

Poland (PL)

PL identified the following issues when assessing compliance with the DoD:

- deficiencies in the consistent identification of default of a single obligor within the group;
- erroneous counting of DpD for leasing exposures;
- uncertain impact of the introduction of the new DoD on own funds requirements;
- insufficient justification and documentation of some aspects of the DoD;
- pending confirmation regarding the correctness and appropriateness of the final implementation of the new DoD.

Furthermore, specifically concerning cooperative banks, it has been observed that they face IT challenges, but these were not specifically related to the DoD. For instance, in the case of one bank, among other things, differences in determining overdue days necessitate the use of separate IT systems/modules in this regard.

Slovenia (SI)

During the various OSIs, SI did identify non-alignment with the DoD GLs, but considered it not material.

The main deficiencies (SI's smaller banking sector size should be taken into account here) identified were the following:

- Past-due criterion in the identification of default: in one bank, SI identified the miscounting of DpD for some / a number of retail clients.
- Indications of UTP: SI noted the lack of clear rules when UTP tests were performed, and missing guidance on UTP criteria. Furthermore, one bank did not have clear definitions of UTP events. Also, SI noted an inadequate process for forbearance event detection and identification. Furthermore, the BSI reports a case where there was misalignment between the DoD and default events wherein the process of developing models and the definition of default events in terms of insolvency proceedings were found to be inconsistent with the definition used for internal credit risk management.
- Conditions for the return to non-defaulted status: the process of a debtor's exit from defaulted status was not automated at one institution but carried out manually. The institution did not clearly define and embed exit criteria for a uniform assessment of whether the debtor has met all the conditions for recovery and transition from defaulted status. There were also no formalised internal policies and procedures.
- Application of the DoD in a banking group: another finding was that one bank determined DpD on a debtor basis instead of at consolidated level (wrong application of DoD in a banking group).

For the detected deficiencies, institutions accepted the findings and suggested follow-up actions.

Sweden (SE)

For the DoD implementation, SE reviewed banks' internal process documents, technical documents, reports from internal audit and risk control functions. Based on that assessment review, whenever an application was assessed to be partly missing or non-compliant with regard to a paragraph in EBA/GL/2016/07 it was mandatory for the model experts to document the reasoning for the assessment.

This method presumed that banks have documented their applications sufficiently. Banks were given an opportunity to provide missing information and/or describe during meetings details that were lacking in the initial application. Based on this information the model experts then assessed the compliance level for each DoD guideline.

5.5 Assessment of benchmark 3

In order to evaluate the effectiveness of the CAs' supervisory frameworks to ensure compliance with and adequate implementation of the DoD, the PRC established benchmark criteria as described in section 5.1.

With regard to **criterion 1**, the whole sample of CAs is rated '**fully applied**' as the PRC observes that the necessary framework methodologies are in place.

With regard to **criterion 2**, all CAs have a duly documented framework/methodology in place and all are rated '**largely applied**' (ECB, GR, LI, PL, SI and SE) on the criterion.

Regarding the ECB, the PRC observes that the framework for the supervisory assessment of DoD compliance and implementation is clearly specified and documented for IRBA banks. For the latter, the ECB has very comprehensive frameworks in place to ensure a thorough assessment of the DoD. With regard to SA banks, the frameworks in place to target the DoD assessment are less formalised (which also stems from the fact that the regulation is less precise than for IRBA banks) and not always documented. Unlike for IRBA banks, no additional specific guidance for SA banks has been issued so far. Changes in the DoD are identified during/within the SREP.

In the same vein, GR, LI, PL, SI and SE also do not have a complete / well-documented process in place for SA banks to determine, for example, whether an on-site inspection is required to further assess DoD-related deficiencies identified during ongoing supervisory activities (e.g. the SREP, thematic reviews). The PRC notes that this is determined on the basis of supervisory priorities (set on an annual basis) or on an ad hoc basis.

Consequently all CAs were rated '**largely applied**' by the PRC.

With regard to **criterion 3**, five CAs (ECB, GR, LI, PL and SI) are rated '**largely applied**' by the PRC and one CA (SE) '**partially applied**'.

Regarding the ECB, GR, LI, PL and SI, for SA banks no holistic DoD-related on-site inspections were performed. Instead, certain elements of the DoD were assessed as part of broader-scope credit risk or IFRS 9 inspections.

As for SE, the DoD-related material changes to IRBA models were not assessed by means of on-site inspections. Instead, the application packages were reviewed by means of off-site/desktop reviews. As a consequence, some elements such as the correct application of the DoD in the banks' IT systems cannot be fully checked upon.

With regard to **criterion 4**, five CAs (ECB, GR, LI, PL and SI) are considered '**fully applied**' by the PRC, whereas one CA (SE) is rated '**largely applied**'.

Regarding the ECB, GR, LI, PL and SI, a formalised remediation process is in place to address cases of non-compliance which were supported by supervisory measures.

For SE, the approach taken to approve applications for material model changes was the rejection of any incomplete applications. Most banks then resubmitted one more time, leading to the approval of the application without the need for any remedial actions. For one bank minor deficiencies were identified following the off-site supervisory assessment of the material model change applications, and the CA requested a remediation plan, including capital-related measures to address the risk of underestimating own funds requirements until appropriate remediation. Other CAs, e.g. the ECB, on the other hand, provided a number of examples of capital add-ons until remediation actions were completed as an additional incentive to address model-related deficiencies in timely fashion.

With regard to **critterion 5**, four CAs (ECB, GR, PL and SI) are rated **‘fully applied’** by the PRC, whereas two CAs (LI and SE) are considered **‘partially applied’**.

Regarding the ECB, GR, PL and SI, the assessment frameworks cover all aspects of the GLs and proportionality pertaining to the complexity of the supervised institution is considered. In particular, the SSM approach, where IRBA banks have been subject to a higher degree of scrutiny than SA banks, reflects this proportionality, given that the majority of the institutions that apply the IRBA are considered significant. By contrast, the less significant institutions generally apply the SA approach and are under the direct supervision of the respective NCAs.

Concerning LI, the FMA has not performed any specific analysis or checks for SA banks regarding the past due criteria in the identification of default, the pulling effect, the materiality threshold for joint exposures and conditions for the return to non-defaulted status.

As for SE, no specific analysis or checks were performed for SA banks regarding the past due criteria in the identification of default. Therefore, not all elements of the GLs are considered covered.

	ECB	GR	LI	PL	SI	SE
Criterion 1	FA	FA	FA	FA	FA	FA
Criterion 2	LA	LA	LA	LA	LA	LA
Criterion 3	LA	LA	LA	LA	LA	PA
Criterion 4	FA	FA	FA	FA	FA	LA
Criterion 5	FA	FA	PA	FA	FA	PA
Overall score for benchmark 3	LA	LA	LA	LA	LA	PA

5.6 Conclusions / findings / best practices

The following **conclusions** can be gleaned from benchmark 3: generally, the PRC is of the opinion that CAs have faithfully implemented the GLs with two areas of attention: (i) differences in the framework methodologies in place and assessment practices applied, and (ii) deficiencies due to

wrong application of the DoD GLs. The main issues encountered with the implementation are the concept of the application of UTP, implementation of guidance on the DoD in a banking group and the relevance of properly defining and embedding exit criteria.

Differences in the framework methodologies in place and assessment practices applied

Most CAs have clear and documented framework methodologies in place, but standardisation thereof could further harmonise the application of the DoD especially in SA portfolios. The frameworks typically reflect the characteristics of institutions under supervision, and are to some extent considered 'proportionate'. For example, the ECB, as the CA responsible for the largest complex institutions and covering most of the IRBA models, relies heavily on sophisticated routines and procedures to assess the application of the DoD. LI, on the other hand, needs a far less stringent framework and maybe does not need to cover all aspects, having only LSIs using the SA and little in the way of defaults due to the nature of its banking industry. As a third example, GR has added specific guidance which can be considered part of its framework.

Although CAs use the same 'building blocks' to assess the implementation of the DoD, the assessment practices differ especially in the LSI/SA area. Determining best practices and expectations for assessments including for SA, and streamlining and providing guidance on what constitutes 'proportionality' could help further align the application of the DoD in the EU/EEA. All CAs evaluated the application of the DoD in the institutions under their supervision. The PRC noted, however, diverging practices across jurisdictions on how they assess the implementation of the DoD GLs for the institutions under their supervision. This includes, for example, the assessment type applied (e.g. OSI/IMI, off-site, audits, horizontal), selection criteria (how to target institutions), scope (DoD-specific areas, DoD holistically, DoD as part of larger exercises), timing (which year), frequency (how often, how regular), and depth (what evidence is reviewed incl. IT), as well as the data basis used for sampling and analysis (e.g. AnaCredit or other sources). Best practices vary across the various building blocks. On methodology, CAs in the SSM do rely on the ECB operational guidance for OSIs, but with 'proportionate adaptations' to make the methodology fit their respective jurisdiction.

Deficiencies in application of the DoD GLs

Most deficiencies were observed in relation to the implementation of guidance on UTP, the consistent application of the DoD in a banking group and the proper embedment of exit criteria. DoD counting in general seems clear, although some irregularities were found. On UTP, institutions struggle with applying UTP criteria, especially in the area of 'distressed restructuring'. CAs further note that institutions did not properly and consistently apply the guidance on the DoD in a banking group, despite the GLs and supervisory expectations. Lastly, although exit criteria are clearly described in the GLs, CAs note that they are not always properly implemented by institutions.

Most CAs cover remediation and follow-up in regular supervision as well as the SREP process. CAs use typical supervisory tools to enforce compliance if necessary – sanctions, fines, capital add-ons

or dismissal of management in extreme cases. As best practice, CAs mention active communication on the progress of remediation between regular supervision and on-site experts.

In terms of **best practices**, the PRC considers the level of standardisation deployed by the ECB for the IRBA a 'best practice'. For banks using the SA approach, the PRC concludes that further standardisation is desirable, as observed differences in assessment methodologies across CAs could be manifested in an unwarranted and heterogeneous implementation of the DoD.

In addition, the use of specifically designed tools and techniques should be highlighted: more specifically, the ECB and GR using AnaCredit (separately) to identify cases where exposures to the same creditors have been treated inconsistently across different institutions.

Besides using prudential data, the ECB also relies on AnaCredit data to identify potential weaknesses in default identification through the analysis of instrument-level data on common borrowers (i.e. counterparts of an SSM bank with at least two different creditors). Given the complexity of managing millions of records, the ECB's horizontal department translated the data into a ready-to-use format. This allows line supervisors to extract and identify a list of potentially misclassified borrowers across their supervised entities. The tool is now common practice, and accessible to all CAs in the SSM.

In addition to FINREP and COREP, SI also relies on more granular national reporting (matrix reporting) where monthly data is used to enable the detection of past due and new clients, as well as reclassifications. Moreover, instrument-level data is also available in addition to client-based data. The reporting matrix includes a large number of additional parameters, including credit risk parameters, such as UTP triggers.

6. Conclusions and recommendations

The verification of Article 178 of the CRR and checks on the application of the DoD require ongoing supervision as institutions are continuously improving their compliance with the regulatory requirements.

Overall, the PRC found that most of the targeted CAs in this peer review performed well and invested a substantial amount of effort and attention in the implementation of the DoD GLs. Consequently, the CAs were mostly rated 'fully applied' or 'largely applied' according to the predefined assessment criteria/benchmarks.

While the implementation and application of the DoD GLs for IRBA banks are generally ensured by, coordinated with or done in conjunction with the ECB, for SA banks under the supervision of NCAs differing practices were identified. These differences are often linked to the structure of their national banking sector and CAs' supervisory priorities and their judgement on the urgency of checking the application of the DoD versus other supervisory elements. A certain level of flexibility to adapt to those parameters should be accepted. Overall, including for SA banks, the PRC did not discover any major supervisory deficiencies. Only for SE, as mentioned in section 5.5, were a

number of deficiencies uncovered. While these provide room for improvement, the PRC notes, however, that no major issues with any SE SA banks were identified.

Against this backdrop, in particular the ECB's holistic DoD project and substantial commitment to follow-up supervision covering the largest part of IRBA institutions within the EU shows a coordinated approach, ensuring consistency in the assessment of the DoD, and should be considered best practice. At the same time, some gaps in the application of the DoD GLs remain, especially when it comes to SA banks and monitoring their ongoing compliance.

While most CAs have clear and documented framework methodologies in place (as demonstrated in section 5.2), there is room for further coordination or standardisation of the latter as well as of the follow-up supervision of SA banks and portfolios. This could include determining best practices and expectations for assessments for SA banks, as well as aligning/providing guidance on:

- the elements used if DoD checks are conducted on the basis of risk-based supervision and/or SREP assessments (e.g. ECB, LI, SI and SE);
- potential alignment of SAQs on the DoD;
- minimum checks on IT systems, especially relevant for SA banks;
- alignment of remedial actions in the context of local versus cross-border institutions.

Streamlining and providing guidance on what constitutes 'proportionality' could help further align the application of the DoD in the EEA. In this context, a comparison of GR and LI provides a good example. GR, having come from a situation with high NPL levels, provided a substantial amount of tailored guidance to its (mostly SA) banks, and deployed a number of different supervisory practices to make sure to cover the DoD implementation for the largest part of its banking sector on a regular basis. LI, on the other hand, due to the structure of its banking sector, and low NPL levels, had to provide much less additional guidance.

6.1 Follow-up measures for CAs / recommendations

Although, as indicated in the previous paragraph, most of the targeted CAs in this peer review performed well and mostly fully or largely applied the predefined assessment criteria/benchmarks, the PRC has identified the following specific follow-up measures/recommendations for CAs:

- for PL and SE, evaluate the need to provide additional guidance to banks on the implementation of the GLs in those areas that have proven to be less harmonised among the banks within their jurisdiction (e.g. exit criteria, UTP indicators, etc.);
- for SE, in particular the following three elements should be added as ongoing supervisory measures to the supervisory toolkit on a permanent basis:

- on-site inspections for material changes to IRBA models and the related checks on IT systems;
 - analysis and checks performed for SA banks regarding the past due criteria in the identification of default improved;
 - improve the assessment framework checks that institutions have adopted the DoD across: a) their systems and processes, b) internal models, c) internal policies;
- for all CAs, document, through internal policy, the supervisory framework for the definition of default for banks using SA for credit risk.

In particular, regarding the last point, it should be considered that, although the request for application of changes to the DoD for SA banks is not required in the regulatory framework, it is of fundamental importance that the CAs have in place framework methodologies for monitoring the correct implementation of the DoD for all banks. In fact, the lack of a thorough assessment of DoD application, e.g. by means of dedicated on-site inspections, in banks using the standardised approach may lead to an increase in unwarranted variability for these institutions, undermining the level playing field at the European banking system level.

Albeit IRB banks are likely to cover the largest part of the banking sector in the MS, SA banks can constitute a non-negligible part of the banking sector of a MS, able to create significant issues in case defaults are not monitored in coherent way. By implementing the above-mentioned follow-up measures and recommendations, CAs can enhance the effectiveness and consistency of DoD implementation across the EU/EEA, ultimately contributing to the stability and integrity of the banking system as a whole.

Annex 1. Peer review committee

Peer reviews are carried out by ad hoc peer review committees composed of staff from the EBA and members of competent authorities and chaired by the EBA staff.

This peer review was carried out by:

Co-chairs

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Norbert de Roij van Zuijdewijn
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Annex 2. List of Competent Authorities subject to the peer review

Country	Competent Authority
ECB/SSM	European Central Bank / Single Supervisory Mechanism
GR	Bank of Greece
PL	Polish Financial Supervision Authority
LI	Financial Market Authority
SE	Financial Supervisory Authority
SI	Bank of Slovenia

Annex 3. Benchmarks and assessment criteria

Benchmark	Assessment criteria
1. EBA Guidelines are fully implemented	<ul style="list-style-type: none"> • CA has fully implemented EBA/GL/2016/07. • All elements of the GL are integrated into CA's practices (e.g. by amending their legal framework or their supervisory practices).
2. The procedure for the submission of the application is effective	<ul style="list-style-type: none"> • There is a procedure for the submission of application in place. • The procedure for submitting the application clearly specified and duly documented.
3. The assessment for checking the compliance of the implementation of the DoD is effective	<ul style="list-style-type: none"> • There is a framework methodology in place. • The CA's assessment framework checks that institutions have adopted the DoD across: a) their systems and processes, b) internal models, c) internal policies. • The assessment framework is clearly specified and duly documented. • In the case of non-compliance, an adequate remediation plan has been adopted. • The assessment framework has covered all aspects of the GLs on the definition of default also taking into account proportionality considerations pertaining to the complexity of the supervised institution.



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