EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Public consultation on the draft ECB Regulation on the materiality threshold for credit obligations past due

Frequently asked questions (FAQs)

What is the purpose of the Regulation?

The Regulation aims to define the threshold against which the materiality of defaults in relation to obligors' total obligations and at the level of individual credit facilities is assessed. The ECB, as competent authority for carrying out microprudential tasks within the Single Supervisory Mechanism (SSM), is required to define such a threshold under Article 178(2)(d) of the Capital Requirements Regulation (CRR).[1]

This materiality threshold has been set in line with the provisions of the Regulatory Technical Standards developed by the European Banking Authority under Article 178(6) of the CRR and adopted by the European Commission by means of the Commission Delegated Regulation (EU) No 2018/171.[2]

What is the effect of the definition of the threshold on the comparability of capital requirements among banks?

The assessment of the various current practices, as outlined in Chapter 2 of the costs and benefits analysis accompanying the draft Regulation, revealed a wide disparity in the application of the materiality threshold within the SSM. The vast range of thresholds currently in place, combined with bank-specific cases, underlines the need for harmonisation in order to ensure a consistent use of the materiality threshold, thus improving the comparability of risk-weighted assets among institutions.

In addition, a consistent use of the materiality threshold within the SSM will also help to reduce the burden of compliance for cross-border groups.

The Regulatory Technical Standards on the materiality threshold for credit obligations past due were published by the EBA in September 2016: why is the ECB only now setting the materiality threshold?

The publication of the final draft Regulatory Technical Standards by the EBA was not a sufficient condition to enable competent authorities to set the materiality threshold. In fact, the Regulatory Technical Standards first needed to be adopted by the European Commission. The Commission Delegated Regulation (EU) No. 2018/171, adopting the Regulatory Technical Standards on the materiality threshold for credit obligations past due, was published in the Official Journal of the European Union on 6 February 2018. Subsequently, the ECB promptly initiated the process for the definition of the level of the materiality threshold for significant institutions within the SSM.

How was the absence of any threshold under Article 178(2)(d) managed until now? Would the industry have considered more default situations if the threshold had been defined earlier?

Currently, as described in Chapter 2 of the costs and benefits analysis accompanying the draft Regulation, different practices apply across the euro area. In some countries, the competent authorities have set materiality thresholds that must be applied by institutions. In other countries, the competent authorities have set materiality thresholds, but institutions have some flexibility to apply different thresholds. In the remaining countries, the choice of the materiality threshold to be applied is left entirely to institutions, as the competent authorities have not set any standards on the materiality threshold. It is worth highlighting that, where materiality thresholds are applied, they differ significantly across countries and/or institutions in terms of both level and structure. With particular reference to significant institutions using the internal

ratings-based (IRB) approach, pending the adoption of a single threshold applicable at SSM level, the ECB permitted these institutions to continue assessing materiality in accordance with the relevant national framework in place.[3]

As regards the second question, if a materiality threshold is set below the level of the threshold currently applied in a particular jurisdiction, the number of defaulted exposures is likely to increase in the short term. Nevertheless, it is expected that institutions that currently apply a higher threshold will also adjust their credit risk management processes, thus reducing the impact on the number of defaults in the medium to long term. In addition, it is worth mentioning that the final effect of a change of the materiality threshold on the number of defaults will not be determined solely by the level of the threshold, but also by its structure, as well as by the interplay with the unlikeliness-to-pay criterion as set out in paragraphs 1(a) and 3 of Article 178 of the CRR.

How did you determine the absolute and relative components of the materiality threshold?

The ECB defined the absolute and relative components of the materiality threshold in line with Article 178(2)(d) of the CRR and Articles 1, 2 and 3 of the Commission Delegated Regulation (EU) No 2018/171.

As set out in these Articles, the chosen threshold is deemed to reflect a reasonable level of risk, since it neither leads to the recognition of an excessive number of defaults that are due to circumstances other than financial difficulties of an obligor, nor to significant delays in the recognition of defaults that are due to financial difficulties of an obligor.

This conclusion was drawn on the basis of qualitative and quantitative considerations, which are outlined in Chapter 4 of the costs and benefits analysis accompanying the draft Regulation. More precisely:

1. The qualitative analysis consisted of a qualitative assessment of the main costs and benefits of different levels of the materiality threshold across several categories. The following elements were analysed: defaults that do not result from financial difficulties; delays in the recognition of defaults; the level of harmonisation; non-performing exposures; credit-impaired exposures (under the accounting standard for financial instruments IFRS 9); own funds requirements; models under the IRB approach; and IT implementation.
2. The quantitative analysis aimed to provide insights supporting the qualitative assessment. This analysis leveraged a data collection exercise carried out on a stratified sample of euro area banks in November 2017.

Why are you asking for industry feedback and what will the next step be?

Under Article 4(3) of the SSM Regulation[4] , before adopting a regulation the ECB is required to conduct open public consultations and analyse the potential related costs and benefits, unless such consultations and analyses are disproportionate in relation to the scope and impact of the regulations concerned or in relation to the particular urgency of the matter. In the specific context of the materiality threshold, both the scope and the impact of the choice of the threshold are deemed to justify a public consultation and a costs and benefits analysis. In fact, the chosen threshold will be binding for all significant institutions within the SSM and will not only influence core functional processes, such as the identification of defaults and therefore risk quantification, but also operative processes such as the management of clients with overdue exposures.

On conclusion of the public consultation, the ECB will assess the feedback received from the industry and incorporate it into the final version of the Regulation where appropriate. The final Regulation will subsequently be published in the Official Journal of the European Union.

To what extent will this be a change for banks?

The implementation of the materiality threshold may have a significant impact on the operations of some institutions, which will not only have to adjust their core functional processes, such as the identification of defaults and thus risk quantification, but also operative processes, such as the management of clients with overdue exposures. This is particularly the case for institutions that currently use a significantly different approach to the materiality of past due exposures.

Besides the impact on processes, adjustments are likely to be necessary in the procedures and IT systems used for the identification of default against the new materiality threshold. Finally, the implementation process might be operationally cumbersome, especially for institutions using the IRB approach, as the IRB risk parameters might have to be recalibrated to reflect the change in the definition of default. Additionally, in accordance with Delegated Regulation (EU) 529/2014[5] , any changes in the definition of default are considered to be material changes to the rating systems and therefore require the approval of a competent

authority. Such considerations and constraints were taken into account by the ECB when defining the timeline for the implementation of the threshold for institutions within the SSM.

Will this result in increases in Pillar 1 capital requirements for any banks?

As elaborated in Section 4.2.5 of the costs and benefits analysis accompanying the draft Regulation, the effect of the new materiality threshold on capital requirements is not straightforward, as it depends on several factors, such as the method used by the institution to calculate capital requirements as well as the level of the materiality threshold currently in place.

It is worth highlighting that any relevant effects stemming from an increase in defaulted exposures in the short term are expected to be mitigated in the medium and long term through adjustments to credit risk management processes.

You mention a costs and benefits analysis of the viable options. How much is this likely to cost the average bank under your supervision?

The requirement to carry out an analysis of the potential costs and benefits for the purposes of adopting a Regulation serves to ensure that the benefits, as well as the drawbacks, stemming from the policy options under examination are appropriately identified and assessed within the decision-making process. As indicated in the answers to Questions 6 and 7 above, there is no straightforward way of calculating the cost for the average bank in terms of an amount. Therefore, for the purpose of the present consultation, the ECB has assessed the costs in terms of drawbacks and/or effects of its policy decision as outlined in Chapter 4 of the costs and benefits analysis accompanying the draft Regulation.

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[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).
[2] Commission Delegated Regulation (EU) 2018/171 of 19 October 2017 on supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for the materiality threshold for credit obligations past due (OJ L 32, 6.2.2018, p. 1).
[3] See ECB Guide on options and discretions available in Union law, March 2016, Section III, page 41, available on the ECB's banking supervision website.
[4] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).
[5] Commission Delegated Regulation (EU) No 529/2014 of 12 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach (OJ L 148, 20.5.2014, p. 36).

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