MFSA
MALTA FINANCIAL SERVICES AUTHORITY

Banking Rule BR/09
Measures addressing Non-Performing Exposures and Forborne Exposures

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REVISIONS LOG

VERSION	DATE ISSUED	DETAILS
1.00	January 2023	Amendments to the Rule to implement the EBA Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No. 575/2013 (EBA/GL/2016/07), the EBA Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses (EBA/GL/2017/06), the EBA Guidelines on management of non-performing and forborne exposures (EBA/GL/2018/06), and the EBA Guidelines on disclosure of non-performing and forborne exposures (EBA/GL/2018/10). Amendments are also being carried out to implement changes to the quantitative requirements for non-performing exposures.

INTRODUCTION

1. In terms of Article 4(7) of the Banking Act 1994, Chap. 371 ('the Act'), the competent authority ('the Authority') as appointed under Article 3(1) of the Malta Financial Services Act, Chap. 330, may make Banking Rules ('the Rules') as may be required for carrying into effect any of the provisions of the Act. The Authority may amend or revoke such Rules. The Rules and any amendment or revocation thereof shall be officially communicated to credit institutions and the Authority shall make copies thereof available to the public.

2. The Rule on measures to address credit risks arising from the assessment of the quality of asset portfolios of credit institutions is being made pursuant to Article 17A of the Act which stipulates that: *"The competent authority may issue a Banking Rule as it considers appropriate for the implementation of measures aimed at addressing credit risks arising from the assessment of the quality of a credit institution's asset portfolio."*

3. It should be emphasised, however, that Rules must not be construed to be solely a substitute for a reading of the Act itself and should be read in conjunction with the Act.

SCOPE AND APPLICATION

4. The Rule applies to credit institutions, as defined in Article 2(1) of the Act.

5. In drafting this Rule, the Authority has been guided by following Guidelines issued by the European Banking Authority (EBA):

   - The Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013 (EBA/GL/2016/07), issued on 18 January 2017;
   - The Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses (EBA/GL/2017/06), issued on 12 May 2017;
   - The Guidelines on management of non-performing and forborne exposures (EBA/GL/2018/06), issued on 31 October 2018.
   - The Guidelines EBA/GL/2018/10 on disclosure of non-performing and forborne exposures (EBA/GL/2022/13).

- The European Central Bank (ECB) Guidance to banks on non performing loans (2017) and its amendment (2019), as well as the Addendum to the ECB Guidance to banks on non performing loans (2018).

6. This Rule specifies the sound risk management practices for credit institutions for managing non-performing exposures (NPEs), forborne exposures (FBEs) and foreclosed assets.

7. This Rule shall apply in relation to Article 74 of Directive 2019/878/EU ('the CRD'), [1]which requires credit institutions to have robust governance arrangements, including a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks they are or might be exposed to and adequate control mechanisms.

8. Credit institutions as defined in Article 2(1) of the Act shall comply with this Rule on an individual, sub-consolidated and consolidated basis in accordance with Article 109 of the CRD.

9. All sections of this Rule shall apply to all exposures subject to definitions of non-performing and forbearance as defined in Annex V to Commission Implementing Regulation (EU) No 451/2021 as amended from time to time.[2]

10. For the purposes of the abovementioned definitions of non-performing and forborne exposures in Annex V to Commission Implementing Regulation (EU) No 451/2021, trading exposures include the exposures in the trading book defined in point 86 of Article 4(1) of the CRR[3].

[1] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, as amended from time to time, and includes any binding legal instruments, guidelines and other measures that may be issued thereunder

[2] Commission Implementing Regulation (EU) 2021/451 of 17 December 2020 laying down implementing technical standards for the application of Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to supervisory reporting of institutions and repealing Implementing Regulation (EU) No 680/2014.

[3] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012, as amended from time to time, and includes any binding legal instruments, guidelines and other measures that havebeen or may be issued thereunder.

11. Credit institutions with a gross NPL ratio equal to or greater than 5% on consolidated, sub-consolidated or solo level shall apply Sections 4.1 and 4.2 of this Rule.

    Following a consultation with the Central Bank of Malta, being the authority vested with a macro-prudential function, the authority reserves the right to review and amend the 5% threshold and/or the provisions of Part 1 of this Rule on the Regulatory Allocation and Quantitative Requirements for NPEs, based on objective reasons. The authority shall also consult with credit institutions on any proposed amendments, whilst reserving the right to propose amendments to any other part of this Rule.

12. The Authority may require credit institutions with a gross NPL ratio below the 5% level but which have a high share or material amount of NPEs in an individual portfolio or individual portfolios with a specific concentration of NPEs in a geographical region, an economic sector or a group of connected clients, to apply Sections 4.1 and 4.2 at the level of these portfolios.

13. Furthermore, the Authority may identify credit institutions other than those covered in paragraph 11 that should also apply Sections 4.1 and 4.2.

14. All credit institutions shall apply Sections 4.3 to 4.6.

15. Credit institutions shall comply with this Rule in a manner that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities; in particular, credit institutions may comply with Sections 4.1 and 4.2 taking into account the proportionality criteria specified in Part 1 of the BR/24 on Internal Governance. The principle of proportionality in the application of this Rule will relate in particular to simplified obligations for the operationalisation and governance arrangements supporting the NPE strategies of credit institutions (section 4.1).

16. The provisions in this Rule should complement the Supervisory Review and Evaluation Process (SREP), ensuring a risk-based approach to supervision and taking into account the systemic importance of the institution.

DEFINITIONS

17. For the purposes of this Rule, unless the context otherwise requires, the following shall apply:

"*cure period*" shall mean cure period as defined in paragraph 231 of Annex V to Commission Implementing Regulation (EU) No 451/2021.

"*EBITDA*" shall mean earnings before interest, taxes, depreciation and amortisation.

"*forbearance*" shall mean forbearance measures as referred in Annex V to Commission Implementing Regulation (EU) No 451/2021.

"*forborne exposures (FBEs)*" shall mean exposures in respect to which forbearance measures have been applied in accordance with Annex V to Commission Implementing Regulation (EU) No 451/2021.

"*foreclosed assets*" shall mean assets obtained by taking possession of collateral and which remain recognised on the Statement of Financial Position. Foreclosed assets can be obtained through judicial procedures, through bilateral agreement with the borrower or through other types of collateral transfer from the borrower to the credit institution. Foreclosed assets may include financial and non-financial assets and should include all collateral obtained irrespective of accounting classification.

"*immovable property*" shall mean immovable property as defined in Article 208 of the CRR.

"*liquidation cost*" shall be defined as the cash outflows incurred during collateral execution and the sales process and include:
a. all applicable legal costs;
b. selling costs, taxes and other expenses;
c. any additional maintenance costs to be incurred by the credit institution in relation to the repossession and disposal of the collateral;
d. any cash inflows up to the date of liquidation.

"*movable property*" shall mean the physical property other than immovable property in accordance with Article 210 of the CRR.

"*non-performing exposures (NPEs)*" shall mean exposures classified as non-performing in accordance with Annex V to Commission Implementing Regulation (EU) No 451/2021.

"*non-performing loans (NPLs)*" shall mean loans and advances as defined in Annex V to Commission Implementing Regulation (EU) No 451/2021 that are classified as non-performing in accordance with 451/2021such Regulation.

"*NPL ratio*" is the gross carrying amount of NPLs and advances, divided by the gross carrying amount of total loans and advances in accordance with the NPE definition.

"*NPE framework*" shall mean the policies, processes, controls and systems for risk management of NPEs.

"*portfolio*" shall mean a group of exposures with similar credit risk characteristics.

"*probation period*" shall mean probation period as defined in Annex V to Commission Implementing Regulation (EU) No 451/2021.

"*risk appetite framework (RAF)*" shall mean the overall approach, including policies, processes, controls and systems, through which risk appetite is established, communicated and monitored. It includes a risk appetite statement, risk limits and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the credit institution, as well as to its reputation with depositors, investors and customers. The RAF aligns with the credit institution's strategy.

"*texas ratio*" shall mean the ratio which compares the stock of NPLs with a credit institution's equity. NPLs (gross carrying amount) over equity and accumulated impairment losses.

Words and expressions used in this Rule which are also used in the Act and the CRR but which are not defined herein, shall have the same meaning assigned to them as in the Act and the CRR.

18. For the first application of this Rule, credit institutions shall calculate their NPL ratios using the reference date of year end December 2022.

PART 1 – QUANTITATIVE REQUIREMENTS FOR NPEs

1.1 Regulatory Allocation

19. The authority requires that a regulatory allocation shall be made by a credit institution against the level of its non-performing exposures. Thus, the authority expects credit facilities categorised as non-performing according to paragraph 17 to be fully eligible for the purposes of a regulatory allocation in terms of this Rule. This means that for the purposes of the methodology of this Rule, the regulatory allocation shall be based on a credit institution's level of non-performing exposures as guided by section 1.2 (Quantitative Requirements) below. Section 1.2 is not applicable to Significant Institutions as they shall be guided by the ECB Guidance (March 2017) and Addendum (March 2018 and amendment of August 2019) on non-performing loans.

20. This Rule provides for a regulatory allocation that sets the minimum amount of coverage expectations against the level of NPEs, to bridge any insufficient coverage resulting after impairments are recognised in line with IFRSs as adopted by the EU. Credit institutions are to apply these coverage expectations separately for each non-performing exposure. Such approach aims to better reflect the inherent risk of the respective NPEs. Nevertheless, the authority expects a credit institution to undertake its own assessment and reasoned judgement on the possibility of timely recovery of funds and provide an enhanced level of regulatory allocation as may be required and merited in such circumstances.

1.2 Quantitative Requirements

21. Regulation (EU) 2019/630, amending the CRR, as regards minimum loss coverage for non-performing exposures, established statutory prudential treatment under Pillar 1 for NPEs arising from loans originated from 26 April 2019 onwards. In these instances, credit institutions are required to deduct from own funds for NPEs which are not sufficiently covered by provisions or other adjustments. The specific applicable amount of insufficient coverage to be deducted from Common Equity Tier 1 items shall be determined separately for each NPE pursuant to the criteria set out in Article 47c of the CRR.

22. NPEs resulting from loans originated *before* 26 April 2019 do not fall within scope of Regulation (EU) 2019/630 but are to meet coverage expectation paths depending on the respective date of NPE classification, as outlined in Table 1 below.

    Loans originated *before* 26 April 2019 and classified as NPE *before* 26 April 2019 are to be treated as 'stock NPEs'. For stock NPEs, there is no coverage expectation in the first 7 years, after which credit institutions are expected to, as a minimum, follow the coverage expectations as indicated in Table 1, column 2 below. These coverage expectations shall start from a minimum of 40% upon publication of this Rule and reach 100% after 7 years. Table 2 provides guidance on how to apply such coverage. However, the 40% coverage in year 1 is a non-binding requirement (to be evidenced in the ICAAP for 2023). Coverage expectations are binding from the end of year 1 (50%) onwards, ending with 100% during 2028. These coverage expectations are applicable on the total book value of the stock NPE, that is the type and value of collateral held against these loans shall not be considered in the calculations.

Table 1 – Minimum Coverage expectations calendar for NPEs

	NPE Category			
	Classified as NPE before and including 26 April 2019 (Stock NPEs)	*Classified as NPE after 26 April 2019 (Flow NPEs)*		
	Total NPE book value	Collateralised by Immovable	Collateralised by Movable	Unsecured
Year 1	40%	0%	0%	0%
Year 2	50%	0%	0%	35%
Year 3	60%	25%	25%	100%
Year 4	70%	35%	35%	
Year 5	80%	55%	55%	
Year 6	90%	70%	80%	
Year 7	100%	80%	100%	
Year 8		85%		

Year 9		100%		

Note: In the case of column (2), the 40% for year 1 is non-binding and year 2 starts from end December 2023. For columns (3), (4) and (5), year 1 refers to the year subsequent to the first year of NPE classification.

Table 2 – Minimum Coverage expectations calendar for Stock NPEs

NPE Classification date	*Year when NPE exceeds 7 years threshold*	*NPE years exceeding the 7-year threshold and captured within the Stock NPE bucket*	*Applicable coverage expectations factor*
2015 (and earlier)	2022	2015 (and earlier)	40%
2016	2023	2015 (and earlier) + 2016	50%
2017	2024	2015 (and earlier) + 2016 + 2017	60%
2018	2025	2015 (and earlier) + 2016 + 2017 + 2018	70%
2019	2026	2015 (and earlier) + 2016 + 2017 + 2018 + 2019	80%
	2027	2015 (and earlier) + 2016 + 2017 + 2018 + 2019	90%
	2028	2015 (and earlier) + 2016 + 2017 + 2018 + 2019	100%

Loans originated *before* 26 April 2019 and classified as NPEs *after* 26 April 2019, referred to as 'flow NPEs', also do not fall within scope of Regulation (EU) 2019/630. Based on the type of underlying collateral and depending on the number of years

for which a loan has been classified as NPE, credit institutions are expected to apply the corresponding minimum coverage expectations: (i) for parts of NPEs secured by immovable collateral, minimum coverage expectations shall start from 0% on year 1 (the year subsequent to the first year of NPE classification), and reach 100% after 9 years (see table 1, column 3); (ii) for parts of NPEs secured by other types of collateral, minimum coverage expectations shall start from 0% on year 1 and reach 100% after 7 years (see table 1, column 4) and (iii) for unsecured parts of NPEs, minimum coverage expectations shall start from 0% on year 1 and reach 100% after 3 years (see table 1, column 5).

23. These minimum coverage expectations aim to ensure that credit institutions do not build up legacy NPEs with insufficient provision coverage. It is considered that prudent provisioning implies the continuation of booking accounting provisions in line with banks' assessments and applicable accounting principles.

24. The authority considers the allocation of funds as a capital buffer via this methodology as a Pillar II measure. The appropriation for the legacy NPEs shall be affected from the profits for the year. Appropriation in any other form, including deductions from surplus CET1 capital shall be approved by the authority on a case-by-case basis. The authority expects credit institutions to present the respective provision calculations in line with this Rule in their annual Internal Capital Adequacy Assessment Process (ICAAP), including an aggregate of the NPE classifications for legacy NPEs, their corresponding provisions and capital deductions.

25. The above actions are without prejudice to the authority invoking its power to restrict or prohibit distributions (in general) by a credit institution to its shareholders. As the allocation of funds via this capital buffer is a Pillar II measure, the authority reserves the right to increase the applicable metrics for any particular credit institution as may be required. This will be done according to that credit institution's risk profile as set out in its ICAAP and as assessed by the authority through the applicable SREP.

PART 2 – APPLICATION OF THE DEFINITION OF DEFAULT UNDER ART. 178 OF CRR

26. This Part of the Rule specifies the requirements on the application of Article 178 of the CRR on the definition of default.

27. This Part of the Rule shall apply in relation to the Standardised Approach for credit risk by virtue of the reference to Article 178 in Article 127 of the CRR.

2.1 Past due criterion in the identification of default

2.1.1 Counting of days past due

28. For the purposes of the application of point (b) of Article 178(1) of the CRR, where any amount of principal, interest or fee has not been paid at the date it was due, credit institutions shall recognise this as the credit obligation past due. Where there are modifications of the schedule of credit obligations, as referred to in point (e) of Article 178(2) of the CRR, the credit institution's policies shall clarify that the counting of days past due shall be based on the modified schedule of payments.

29. Where the credit arrangement explicitly allows the obligor to change the schedule, suspend or postpone the payments under certain conditions and the obligor acts within the rights granted in the contract, the changed, suspended or postponed instalments shall not be considered past due, but the counting of days past due shall be based on the new schedule once it is specified. Nevertheless if the obligor changes the schedule, suspends or postpones the payments, the credit institutions shall analyse the reasons for such a change and assess the possible indications of unlikeliness to pay, in accordance with Articles 178(1) and (3) of the CRR and Section 2.2 of this Rule.

30. Where the repayment of the obligation is suspended because of a law allowing this option or other legal restrictions, the counting of days past due shall also be suspended during that period. Nevertheless, in such situations, credit institutions shall analyse, where possible, the reasons for exercising the option for such a suspension and shall assess the possible indications of unlikeliness to pay, in accordance with Articles 178(1) and (3) of the CRR and Section 2.2 of this Rule.

31. Where the repayment of the obligation is the subject of a dispute between the obligor and the credit institution, the counting of days past due may be suspended until the dispute is resolved, where at least one of the following conditions is met:
    a. the dispute between the obligor and the credit institution over the existence or amount of the credit obligation has been introduced to a court or another formal procedure performed by a dedicated external body that results in a binding ruling in accordance with the applicable legal framework in the relevant jurisdiction;

    b. in the specific case of leasing, a formal complaint has been directed to the credit institution about the object of the contract and the merit of the complaint has been confirmed by independent internal audit, internal validation or another comparable independent auditing unit.

32. Where the obligor changes due to an event such as a merger or acquisition of the obligor or any other similar transaction, the counting of days past due shall start from the moment a different person or entity becomes obliged to pay the obligation. The counting of days past due is, instead, unaffected by a change in the obligor's name.

33. The calculation of the sum of all amounts past due that are related to any credit obligation of the obligor to the credit institution, parent undertaking or any of its subsidiaries to this obligor and which credit institutions are required to calculate for the purpose of comparison with the materiality threshold referred to in paragraph 45 shall be performed with a frequency allowing timely identification of default. Credit institutions shall ensure that the information about the days past due and default is up to date whenever it's being used for decision making, internal risk management, internal or external reporting and the own funds requirements calculation processes. Where credit institutions calculate days past due less often than daily, they shall ensure that the date of default is identified as the date when the past due criterion has actually been fulfilled.

34. The classification of the obligor to a defaulted status shall not be subject to additional expert judgement; once the obligor meets the past due criterion all exposures to that obligor are considered defaulted, unless either of the following conditions is met:
    a. the exposures are eligible as retail exposures and the credit institution applies the default definition at individual credit facility level;

b. a so called 'technical past due situation' is considered to have occurred, in accordance with paragraph 35.

2.1.2 Technical past due situation

35. A technical past due situation shall only be considered to have occurred in any of the following cases:
    a. where a credit institution identifies that the defaulted status was a result of data or system error of the credit institution, including manual errors of standardised processes but excluding wrong credit decisions;

    b. where a credit institution identifies that the defaulted status was a result of the non-execution, defective or late execution of the payment transaction ordered by the obligor or where there is evidence that the payment was unsuccessful due to the failure of the payment system;

    c. where due to the nature of the transaction there is a time lag between the receipt of the payment by a credit institution and the allocation of that payment to the relevant account, so that the payment was made before the 90 days and the crediting in the client's account took place after the 90 days past due;

    d. in the specific case of factoring arrangements where the purchased receivables are recorded on the balance sheet of the credit institution and the materiality threshold referred to in paragraph 45 is breached but none of the receivables to the obligor is past due more than 30 days.

36. Technical past due situations shall not be considered as defaults in accordance with Article 178 of the CRR. All detected errors that led to technical past due situation shall be rectified by the credit institution in the shortest timeframe possible.

2.1.3 Exposures to central governments, local authorities and public sector entities

37. Credit institutions may apply specific treatment for exposures to central governments, local authorities and public sector entities where all of the following conditions are met:
    a. the contract is related to the supply of goods or services, where the administrative procedures require certain controls related to the execution of the contract before

the payment can be made; this applies in particular to factoring exposures or similar types of arrangements but does not apply to instruments such as bonds;

b. apart from the delay in payment no other indications of unlikeliness to pay as specified in accordance with Article 178(1)(a) and 178(3) of the CRR and this Rule applies, the financial situation of the obligor is sound and there are no reasonable concerns that the obligation might not be paid in full, including any overdue interest where relevant;

c. the obligation is past due not longer than 180 days.

38. Credit institutions that decide to apply the specific treatment referred to in paragraph 37 shall apply all of the following:
    a. these exposures shall not be included in the calculation of the materiality threshold for other exposures to this obligor;

    b. they shall not be considered as defaults in the sense of Article 178 of the CRR;

    c. they shall be clearly documented as exposures subject to the specific treatment.

2.1.4 Specific provisions applicable to factoring and purchased receivables

39. Where there are factoring arrangements whereby the ceded receivables are not recognised on the balance sheet of the factor and the factor is liable directly to the client up to a certain agreed percentage, the credit institution shall commence the counting of days past due from when the factoring account is in debit, i.e. from when the advances paid for the receivables exceed the percentage agreed between the factor and the client. For the purpose of determining items of the client of a factor that are past due, credit institutions shall apply both of the following:
    a. compare the sum of the amount of the factoring account that is in debit and all other past due obligations of the client recorded in the balance sheet of the factor, against the absolute component of the materiality threshold referred to in paragraph 45.

    b. compare the relation between the sum described in point (a) and the total amount of current value of the factoring account, i.e. the value of advances paid for the receivables and all other on-balance sheet exposures related with the credit

obligations of the client, against the relative component of the materiality threshold referred to in paragraph 45.

40. Where there are factoring arrangements where the purchased receivables are recognised on the balance sheet of the factor and the factor has exposures to the debtors of the client, the counting of days past due shall commence when the payment for a single receivable becomes due.

41. Where the credit institution recognises events related to dilution risk of purchased receivables as defined in point (53) of Article 4(1) of the CRR, these events shall not be considered as leading to the default of the obligor. Where the amount of receivable has been reduced as a result of events related to dilution risk such as discounts, deductions, netting or credit notes issued by the seller the reduced amount of receivable shall be included in the calculation of days past due. Where there is a dispute between the obligor and the seller, and such event is recognised as related to dilution risk the counting of days past due shall be suspended until the dispute is resolved.

42. Events recognised as related to dilution risk and hence excluded from the identification of default shall be included in the calculation of own funds requirements or internal capital for dilution risk. Where credit institutions recognise significant number of events related to dilution risk, they shall analyse and document the reasons for such events and assess the possible indications of unlikeliness to pay, in accordance with Articles 178(1) and (3) of the CRR and Section 2.2 of this Rule.

43. Where the obligor has not been adequately informed about the cession of the receivable by the factor's client and the credit institution has evidence that the payment for the receivable has been made to the client, the credit institution shall not consider the receivable to be past due. Where the obligor has been adequately informed about the cession of the receivable but has nevertheless made the payment to the client, the credit institution shall continue counting the days past due according to the conditions of the receivable.

44. In the specific case of undisclosed factoring arrangements, where the obligors are not informed about the cession of the receivables but the purchased receivables are recognised on the balance sheet of the factor, the counting of days past due shall

commence from the moment agreed with the client when the payments made by the obligors shall be transferred from the client to the factor.

2.1.5 Setting the materiality threshold

45. In terms of Article 178(2)(d) of the CRR concerning the threshold for assessing the materiality of credit obligations past due, the Authority, having regard to the Guideline (EU) 2020/978 of the ECB[4], hereby sets the following thresholds, against which credit institutions shall assess the materiality of a credit obligation past due:
    a. a limit in terms of the sum of all amounts past due owed by the obligor to the credit institution, the parent undertaking of that credit institution or any of its subsidiaries (hereinafter the 'credit obligation past due'), equal:

        i. for retail exposures, to EUR 100;

        ii. for exposures other than retail exposures, to EUR 500; and

    b. a limit in terms of the amount of the credit obligation past due in relation to the total of all on-balance sheet exposures to that obligor for the credit institution, the parent undertaking or any of its subsidiaries, excluding equity exposures, equal to 1%.

46. Credit institutions shall apply the definition of default laid down in points a) and b) of the first subparagraph of Article 178(1) of the CRR for retail exposures at the level of an individual credit facility to apply the thresholds laid down above at the level of the individual credit facility granted to the obligor by the credit institution, the parent undertaking or any of its subsidiaries.

47. A default shall be deemed to have occurred when both of the limits set out in points (a) and (b) above are exceeded for more than 90 consecutive days.

48. Credit Institutions shall apply the materiality threshold for past due credit obligations referred to in paragraph 45. Credit institutions may identify defaults on the basis of a

[4] Guideline (EU) 2020/978 of the ECB of 25 June 2020 on the exercise of the discretion under Article 178(2)(d) of Regulation (EU) No 575/2013 of the European Parliament and of the Council by national competent authorities in relation to less significant institutions with regard to the threshold for assessing the materiality of credit obligations past due (ECB/2020/32).

lower threshold if they can demonstrate that this lower threshold is a relevant indication of unlikeliness to pay and does not lead to an excessive number of defaults that return to non-defaulted status shortly after being recognised as defaulted or decrease of capital requirements. In this case credit institutions shall record in their databases the information on the trigger of default as an additional specified indication of unlikeliness to pay.

2.2 Indications of unlikeliness to pay

2.2.1 Non-accrued status

49. For the purposes of unlikeliness to pay as referred to in point (a) of Article 178(3) of the CRR, credit institutions shall consider that an obligor is unlikely to pay where interest related to credit obligations is no longer recognised in the income statement of the credit institution due to the decrease of the credit quality of the obligation.

2.2.2 Specific credit risk adjustments (SCRA)

50. For the purposes of unlikeliness to pay as referred to in point (b) of Article 178(3) of the CRR, all of the following specific credit risk adjustments (SCRA) shall be considered to be a result of a significant perceived decline in the credit quality of a credit obligation and hence shall be treated as an indication of unlikeliness to pay:
    a. losses recognised in the profit or loss account for instruments measured at fair value that represent credit risk impairment under the applicable accounting framework;

    b. losses as a result of current or past events affecting a significant individual exposure or exposures that are not individually significant which are individually or collectively assessed.

51. Where the credit institution treats an exposure as credit-impaired under IFRS 9, i.e. assigns it to Stage 3 as defined in IFRS 9 Financial Instruments, such exposure shall be considered defaulted, except where the exposure has been considered credit-impaired due to the delay in payment and either or both of the following conditions are met:
    a. the materiality threshold referred to in paragraph 45 has not been breached;

b. the exposure has been recognised as a technical past due situation in accordance with paragraph 35;

c. the exposure meets the conditions of paragraph 37.

2.2.3 Sale of the credit obligation

52. For the purposes of unlikeliness to pay as referred to in point (c) of Article 178(3) of the CRR, credit institutions shall take into account both the character and materiality of the loss related to the sale of credit obligations, in accordance with the following paragraphs. Transactions of traditional securitisation with significant risk transfer and any intragroup sales of credit obligations shall be considered sale of credit obligations.

53. Credit institutions shall analyse the reasons for the sale of credit obligations and the reasons for any losses recognised thereby. Where the reasons for the sale of credit obligations were not related to credit risk, such as where there is the need to increase the liquidity of the institution or there is a change in business strategy, and the credit institution does not perceive the credit quality of those obligations as declined, the economic loss related with the sale of those obligations shall be considered not credit-related. In that case, the sale shall not be considered an indication of default even where the loss is material, on condition of the appropriate, documented justification of the treatment of the sale loss as not credit-related. Credit institutions may, in particular, consider the loss on the sale of credit obligations as non-credit related where the assets subject to the sale are publicly traded assets and measured at fair value.

54. Where, however, the loss on the sale of credit obligations is related to the credit quality of the obligations themselves, in particular where the credit institution sells the credit obligations due to the decrease in their quality, such credit institution shall analyse the materiality of the economic loss and, where the economic loss is material, this shall be considered an indication of default.

55. Credit institutions shall set a threshold for the credit-related economic loss related with the sale of credit obligations to be considered material, which shall be calculated according to the following formula, and shall not be higher than 5%:

$$L = \frac{E - P}{E}$$

where:

L is the economic loss related with the sale of credit obligations;

E is the total outstanding amount of the obligations subject to the sale, including interest and fees;

P is the price agreed for the sold obligations.

56. In order to assess the materiality of the overall economic loss related with the sale of credit obligations, credit institutions shall calculate the economic loss and compare it to the threshold referred to in paragraph 45. Where the economic loss is higher than this threshold the credit institutions shall consider the credit obligations defaulted.

57. The sale of credit obligations may be performed either before or after the default.

58. If the sale of a credit obligation at a material credit-related economic loss occurred before the identification of default on that exposure, the moment of sale shall be considered the moment of default. In the case of a partial sale of the total obligations of an obligor where the sale is associated to a material credit-related economic loss, all the remaining exposures to this obligor shall be treated as defaulted, unless the exposures are eligible as retail exposures and the credit institution applies the default definition at facility level.

59. In the case of a sale of a portfolio of exposures the treatment of individual credit obligations within this portfolio shall be determined in accordance with the manner the price for the portfolio was set. Where the price for the total portfolio was determined by specifying the discount on particular credit obligations, the materiality of credit-related economic loss shall be assessed individually for each exposure within the portfolio. Where however the price was set only at the portfolio level, the materiality of credit-related economic loss may be assessed at the portfolio level and in that case, if the threshold specified in paragraph 45 is breached, all credit obligations within this portfolio shall be treated as defaulted at the moment of the sale.

2.2.4 Distressed restructuring

60. For the purposes of unlikeliness to pay as referred to in point (d) of Article 178(3) of the CRR, a distressed restructuring shall be considered to have occurred when concessions have been extended towards a debtor facing or about to face difficulties in meeting its financial commitments as specified in section 18 (of template related instructions) of Annex V of the Commission Implementing Regulation (EU) No 451/2021.

61. Given that, as referred to in point (d) of Article 178(3) of the CRR, the obligor shall be considered defaulted where the distressed restructuring is likely to result in a diminished financial obligation, where considering forborne exposures, the credit institution shall classify the obligor as defaulted only where the relevant forbearance measures are likely to result in a diminished financial obligation.

62. Credit institutions shall set a threshold for the diminished financial obligation that is considered to be caused by material forgiveness or postponement of principal, interest, or fees, and which shall be calculated according to the following formula, and should not be higher than 1%:

$$DO = \frac{NPV_0 - NPV_1}{NPV_0}$$

where:

DO is diminished financial obligation;

NPV_0 is net present value of cash flows (including unpaid interest and fees) expected under contractual obligations before the changes in terms and conditions of the contract discounted using the customer's original effective interest rate;

NPV_1 is net present value of the cash flows expected based on the new arrangement discounted using the customer's original effective interest rate.

63. For the purposes of unlikeliness to pay as referred to in point (d) of Article 178(3) of the CRR, for each distressed restructuring, credit institutions shall calculate the diminished financial obligation and compare it with the threshold referred to in paragraph 62. Where the diminished financial obligation is higher than this threshold, the credit institution shall consider such exposures as defaulted.

64. If, however the diminished financial obligation is below the specified threshold, and in particular when the net present value of expected cash flows based on the distressed restructuring arrangement is higher than the net present value of expected cash flows before the changes in terms and conditions, credit institutions shall assess such exposures for other possible indications of unlikeliness to pay. Where the credit institution has reasonable doubts with regard to the likeliness of repayment in full of the obligation according to the new arrangement in a timely manner, the obligor should be considered defaulted. The indicators that may suggest unlikeliness to pay include the following:
    a. a large lumpsum payment envisaged at the end of the repayment schedule;

    b. irregular repayment schedule where significantly lower payments are envisaged at the beginning of repayment schedule;

    c. significant grace period at the beginning of the repayment schedule;

    d. the exposures to the obligor have been subject to distressed restructuring more than once.

65. Any concession extended to an obligor already in default, shall lead to classify the obligor as a distressed restructuring. All exposures classified as forborne non-performing in accordance with Annex V of Commission Implementing Regulation (EU) No 451/2021 shall be classified as default and subject to distressed restructuring.

66. Where any of the modifications of the schedule of credit obligations referred to in point (e) of Article 178(2) of the CRR is the result of financial difficulties of an obligor, credit institutions shall also assess whether a distressed restructuring has taken place and whether an indication of unlikeliness to pay has occurred.

2.2.5 Bankruptcy

67. For the purposes of unlikeliness to pay as referred to in point (e) and (f) of Article 178(3) of the CRR, credit institutions shall clearly specify in their internal policies what type of arrangement is treated as an order or as a protection similar to bankruptcy, taking into account all relevant legal frameworks as well as the following typical characteristics of any relevant protection scheme under national law:

a. the protection scheme encompasses all creditors or all creditors with unsecured claims;

b. the terms and conditions of the protection scheme are approved by the court or the Authority;

c. the terms and conditions of the protection scheme include a temporary suspension of payments or partial redemption of debt;

d. the measures involve some sort of control over the management of the company and its assets;

e. if the protection scheme fails, the company is likely to be liquidated.

68. Credit institutions shall treat all arrangements listed in Annex A to Regulation (EU) 2015/848[5] as an order or as a protection similar to bankruptcy.

2.2.6 Other indications of unlikeliness to pay

69. Credit institutions shall specify in their internal policies and procedures other additional indications of unlikeliness to pay of an obligor, besides those specified in Article 178(3) of the CRR. Those additional indications shall be specified per type of exposures, as defined in point (2) of Article 142(1) of the CRR, reflecting their specificities, and they shall be specified for all business lines, legal entities or geographical locations. The occurrence of an additional indication of unlikeliness to pay shall either result in an automatic reclassification to defaulted exposures or trigger a case-by-case assessment and may include indications based on internal or external information.

70. The possible indications of unlikeliness to pay that could be considered by credit institutions on the basis of internal information include the following:
    a. a borrower’s sources of recurring income are no longer available to meet the payments of instalments;

[5] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings.

b. there are justified concerns about a borrower's future ability to generate stable and sufficient cash flows;

c. the borrower's overall leverage level has significantly increased or there are justified expectations of such changes to leverage;

d. the borrower has breached the covenants of a credit contract;

e. the credit institution has called any collateral including a guarantee;

f. for the exposures to an individual: default of a company fully owned by a single individual where this individual provided the credit institution with a personal guarantee for all obligations of a company;

g. for retail exposures where the default definition is applied at the level of an individual credit facility, the fact that a significant part of the total obligation of the obligor is in default;

h. the reporting of an exposure as non-performing in accordance with Annex V of Commission Implementing Regulation (EU) No 451/2021, except where competent authorities have replaced the 90 days past due with 180 days past due in accordance with point (b) of Article 178(1) of the CRR.

71. Credit institutions shall also take into account the information available in external databases, including credit registers, macroeconomic indicators and public information sources, including press articles and financial analyst's reports. The indications of unlikeliness to pay that could be considered by credit institutions on the basis of external information include the following:

a. significant delays in payments to other creditors have been recorded in the relevant credit register;

b. a crisis of the sector in which the counterparty operates combined with a weak position of the counterparty in this sector;

c. disappearance of an active market for a financial asset because of the financial difficulties of the debtor;

d. the credit institution has information that a third party, in particular another credit institution, has filed for bankruptcy or similar protection of the obligor.

72. When specifying the criteria for unlikeliness to pay, credit institutions shall take into consideration the relations within the groups of connected clients as defined in point 39 of Article 4(1) of the CRR. In particular credit institutions shall specify in their internal policies when the default of one obligor within the group of connected clients has a contagious effect on other entities within this group. Such specifications shall be in line with the appropriate policies for the assignment of exposures to individual obligor to an obligor grade and to groups of connected clients in accordance with point (d) of Article 172(1) of the CRR. Where such criteria have not been specified for a non-standard situation, in the case of default of an obligor that is part of a group of connected clients, credit institutions shall assess the potential unlikeliness to pay of all other entities within this group on a case-by-case basis.

73. Where a financial asset was purchased or originated by a credit institution at a material discount, credit institutions shall assess whether that discount reflects the deteriorated credit quality of the obligor and whether there are any indications of default in accordance with Part 2 of this Rule. The assessment of unlikeliness to pay shall refer to the total amount owed by the obligor regardless of the price that the credit institution has paid for the asset. This assessment may be based on the due diligence performed before the purchase of the asset or on the analysis performed for the accounting purposes in order to determine whether the asset is credit impaired.

74. Credit institutions shall have adequate policies and procedures to identify credit frauds. Typically when credit fraud is identified, the exposure is already defaulted on the basis of material delays in payment. However, if the credit fraud is identified before default has been recognised the credit institution shall treat this as an additional indication of unlikeliness to pay.

2.2.7 Governance processes regarding unlikeliness to pay

75. Credit institutions shall establish policies regarding the definition of default in order to ensure its consistent and effective application and in particular they shall have clear policies and procedures on the application of the criteria for unlikeliness to pay as laid down in Article 178(3) of the CRR and all other indications of unlikeliness to pay

as specified by the credit institution, covering all types of exposures as defined in point (2) of Article 142(1) of the CRR, for all business lines, legal entities and geographical locations.

76. With regard to each indication of unlikeliness to pay, credit institutions shall define the adequate methods of their identification, including the sources of information and frequency of monitoring. The sources of information shall include both internal and external sources, including in particular relevant external databases and registers.

2.3 Criteria for the return to a non-defaulted status

2.3.1 Minimum conditions for reclassification to a non-defaulted status

77. For the purposes of the application of Article 178(5) of the CRR, except for situations referred to in paragraph 78, credit institutions shall apply all of the following:
    a. consider that no trigger of default continues to apply to a previously defaulted exposure, where at least 3 months have passed since the moment that the conditions referred to in Articles 178(1)(b) and 178(3) of the CRR cease to be met;

    b. take into account the behaviour of the obligor during the period referred to in point (a);

    c. take into account the financial situation of the obligor during the period referred to in point (a);

    d. after the period referred to in point (a), perform an assessment, and, where the credit institution still finds that the obligor is unlikely to pay its obligations in full without recourse to realising security, the exposures shall continue to be classified as defaulted until the credit institution is satisfied that the improvement of the credit quality is factual and permanent;

    e. the conditions referred to in points (a) to (d) shall be met also with regard to new exposures to the obligor, in particular where the previous defaulted exposures to this obligor were sold or written off.

Credit institutions may apply the period referred to in point (a) to all exposures or apply different periods for different types of exposures.

78. For the purposes of the application of Article 178(5) of the CRR, and where distressed restructuring according to paragraph 60 of this Rule applies to a defaulted exposure, regardless of whether such restructuring was carried out before or after the identification of default, credit institutions shall consider that no trigger of default continues to apply to a previously defaulted exposure, where at least 1 year has passed from the latest between one of the following events:
    a. the moment of extending the restructuring measures;

    b. the moment when the exposure has been classified as defaulted;

    c. the end of the grace period included in the restructuring arrangements.

79. Credit institutions shall reclassify the exposure to a non-defaulted status after at least the one-year period referred to in paragraph 78, where all of the following conditions are met:
    a. during that period a material payment has been made by the obligor; material payment may be considered to be made where the debtor has paid, via its regular payments in accordance with the restructuring arrangements, a total equal to the amount that was previously past-due (if there were past-due amounts) or that has been written-off (if there were no past-due amounts) under the restructuring measures;

    b. during that period the payments have been made regularly according to the schedule applicable after the restructuring arrangements;

    c. there are no past due credit obligations according to the schedule applicable after the restructuring arrangements;

    d. no indications of unlikeliness to pay as specified in Article 178(3) of the CRR or any additional indications of unlikeliness to pay specified by the credit institution apply;

    e. the credit institution does not consider it otherwise unlikely that the obligor will pay its credit obligations in full according to the schedule after the restructuring arrangements without recourse to realising security. In this assessment, credit institutions shall examine in particular situations where a large lumpsum payment

or significantly larger payments are envisaged at the end of the repayment schedule;

f. the conditions referred to in points (a) to(e) shall be met also with regard to new exposures to the obligor, in particular where the previous defaulted exposures to this obligor that were subject to distressed restructuring were sold or written off.

80. Where the obligor changes due to an event such as a merger or acquisition of the obligor or any other similar transaction, the credit institution shall not apply paragraph 79(a). Where the obligor's name changes, instead, credit institutions shall apply that paragraph.

2.3.2 Monitoring of the effectiveness of the policy

81. For the purposes of the application of Article 178(5) of the CRR, credit institutions shall define clear criteria and policies regarding when the obligor can be classified back to non-defaulted status and more in particular, both of the following:
    a. when it can be considered that the improvement of the financial situation of an obligor is sufficient to allow the full and timely repayment of the credit obligation;

    b. when the repayment is actually likely to be made even where there is an improvement in the financial situation of an obligor in accordance with point (a).

82. Credit institutions shall monitor on a regular basis the effectiveness of their policies mentioned in paragraph 81, and in particular monitor and analyse:
    a. the changes of status of the obligors or facilities;

    b. the impact of the adopted policies on cure rates;

    c. the impact of adopted policies on multiple defaults.

83. It is expected that the credit institution would have a limited number of obligors who default soon after returning to a non-defaulted status. In the case of extensive number of multiple defaults the credit institution shall revise its policies with regard to the reclassification of exposures.

84. The analysis of the changes in statuses of the obligors or facilities shall in particular be taken into account for the purpose of specifying the periods referred to in paragraphs 77 and 78. Credit institutions may specify longer periods for the exposures that have been classified as defaulted in the preceding 24 months.

2.4 Consistency in the application of the definition of default

2.4.1 Overview

85. Credit institutions shall adopt adequate mechanisms and procedures in order to ensure that the definition of default is implemented and used in a correct manner, and shall, in particular, ensure:
    a. that default of a single obligor is identified consistently across the credit institution with regard to all exposures to this obligor in all relevant IT systems, including in all the legal entities within the group and in all geographical locations in accordance with paragraphs 86 to 88 or for retail exposures in accordance with paragraphs 97-99.

    b. that one of the following applies:

        i. the same definition of default is used consistently by a credit institution, parent undertaking or any of its subsidiaries and across the types of exposures;

        ii. where different definitions of default apply either within a group or across the types of exposures, the scope of application of each of the default definitions is clearly specified, in accordance with paragraphs 89 to 90;

2.4.2 Consistent identification of default of a single obligor

86. For the purposes of point (a) of paragraph 85, credit institutions shall implement adequate procedures and mechanisms to ensure that the default of a single obligor is identified consistently across the same credit institution with regard to all exposures to this obligor in all relevant IT systems, including in all the legal entities within the group and in all geographical locations where it is active in ways other than via a legal entity.

87. Where the exchange of client data among different legal entities within a credit institution, the parent undertaking or any of its subsidiaries is prohibited by consumer

protection regulations, bank secrecy or other legislation resulting in inconsistencies in the identification of default of an obligor, credit institutions shall inform the Authority of these legal impediments and, if they use the IRB Approach they shall also estimate the materiality of the inconsistencies in the identification of default of an obligor and their possible impact on the estimates of risk parameters.

88. Further, where the identification of default of an obligor in a manner fully consistent across the credit institution, the parent undertaking or any of its subsidiaries is very burdensome, requiring development of a centralised database of all clients or implementation of other mechanisms or procedures to verify the status of each client at all entities within the group, credit institutions need not apply such mechanisms or procedures if they can demonstrate that the effect of non-compliance is immaterial because there are no or very limited number of common clients among the relevant entities within a group and the exposure to these clients is immaterial.

2.4.3 Consistent use of the definition of default across types of exposures

89. For the purposes of point (b) of paragraph 85, a credit institution, parent undertaking or any of its subsidiaries shall use the same definition of default for a single type of exposures as defined in point (2) of Article 142(1) of the CRR. Institutions may use different definitions of default for different types of exposures, including for certain legal entities or for presence in geographical locations in ways other than via a legal entity, where this is justified by the application of significantly different internal risk management practices or by different legal requirements applying in different jurisdictions, in particular by reasons such as:
    a. different materiality thresholds as set by the Authority in paragraph 45 and by other competent authorities in their jurisdictions in accordance with point (d) of Article 178(2) of the CRR;

    b. the use of 180 days instead of 90 days past due for certain types of exposures to which the IRB Approach is applied in some jurisdictions in accordance with point (b) of Article 178(1) of the CRR;

    c. the specification of additional indications of unlikeliness to pay specific for certain legal entities, geographical locations or types of exposures.

90. For the purposes of point (b)(ii) of paragraph 85, and where different definitions of default are applied either across types of exposures in accordance with paragraph 89, the credit institutions shall ensure that the internal procedures relating to the definition of default include both of the following:
    a. that the scope of application of each definition is clearly specified;

    b. that the definition of default specified for a certain type of exposures, legal entity or geographical location is applied consistently to all exposures within the scope of application of each relevant definition of default.

2.5 Application of the definition of default for retail exposures

2.5.1 Level of application of the default definition for retail exposures

91. According to the second sub-paragraph of Article 178(1) of the CRR, in the case of retail exposures, credit institutions may apply the definition of default at the level of an individual credit facility rather than in relation to the total obligations of a borrower. Credit institutions may apply the definition of default at the level of an individual credit facility for all exposures that meet the criteria specified in Article 123 of the CRR, even where some of those exposures have been assigned to a different exposure class for the purpose of assigning a risk weight, such as exposures secured by mortgages on immovable property.

92. Credit institutions shall choose the level of application of the definition of default between obligor and facility for all retail exposures in a way that reflects their internal risk management practices.

93. Credit Institutions may apply the definition of default at the level of an obligor for some types of retail exposures and at the level of a credit facility for others, where this is well justified by internal risk management practices, for instance due to a different business model of a subsidiary, and where there is evidence that the number of situations where the same clients are subject to different definitions of default at different levels of application is kept to a strict minimum.

94. Where credit institutions decide to use different levels of application of the definition of default for different types of retail exposures, according to paragraph 93, they shall ensure that the scope of application of each definition of default is clearly specified and that it is used consistently over time for different types of retail exposures.

95. Where credit institutions use different levels of application of the default definition with regard to certain retail portfolios, the treatment of common clients across such portfolios shall be specified in their internal policies and procedures. In particular, where the exposure to which the definition of default at the obligor level applies fulfils either or both of the conditions of points (a) or (b) of Article 178(1) of the CRR, then all exposures to that obligor shall be considered defaulted, including those subject to the application of the definition of default at individual credit facility level. Where the exposure subject to the application of the definition of default at individual credit facility level meets those conditions, the other exposures to the obligor shall not be automatically reclassified to default status. Credit institutions, however, may classify those other exposures as defaulted on the basis of other unlikeliness to pay considerations, as provided further in paragraphs 97 to 99.

96. The same rule shall apply to the obligors treated under the Standardised Approach, where some exposures to an obligor fulfil the requirements of Article 123 of the CRR while other exposures to the same obligor are in the form of securities and therefore do not qualify as retail. Where an exposure in the form of a security fulfils either or both of the conditions of points (a) or (b) of Article 178(1) of the CRR, all exposures to that obligor shall be considered defaulted. Where the exposure that fulfils the requirements of Article 123 of the CRR meets those conditions and the credit institution applies the definition of default at the individual credit facility level, the other exposures to the obligor shall not be automatically reclassified to default status. Credit institutions, however, may classify those other exposures as defaulted on the basis of other unlikeliness to pay considerations, as provided further in paragraphs 97 to 99.

2.5.2 Application of the definition of default for retail exposures at the facility level

97. Where, in accordance with the second sub-paragraph of Article 178(1) of the CRR, the definition of default has been applied at the level of an individual credit facility with regard to retail exposures, credit institutions shall not consider automatically the different exposures to the same obligor defaulted at the same time. Nevertheless, credit institutions shall take into account that some indications of default are related with the condition of the obligor rather than the status of a particular exposure. This refers in particular to the indications of unlikeliness to pay related with the bankruptcy of the obligor as specified in points (e) and (f) of Article 178(3) of the CRR. Where

such indication of default occurs, credit institutions shall treat all exposures to the same obligor as defaulted regardless of the level of application of the definition of default.

98. Credit institutions shall consider also other indications of unlikeliness to pay and specify, in line with their internal policies and procedures, which indications of unlikeliness to pay reflect the overall situation of an obligor rather than that of the exposure. Where such other indications of unlikeliness to pay occur, the credit institution shall consider all exposures to the obligor as defaulted regardless of the level of application of the definition of default.

99. Additionally, where a significant part of the exposures to the obligor is in default, credit institutions may consider it unlikely that the other obligations of that obligor will be paid in full without recourse to actions such as realising security and treat them as defaulted as well.

2.5.3 Application of the definition of default for retail exposures at the obligor level

100. The application of the definition of default for retail exposures at the obligor level implies that, where any credit obligation of the obligor meets the conditions of points (a) or (b) or both of Article 178(1) of the CRR, then all exposures to that obligor shall be considered defaulted. Credit institutions that decide to apply the definition of default for retail exposures at the obligor level shall specify detailed rules for the treatment of joint credit obligations and default contagion between exposures in their internal policies and procedures.

101. Credit institutions shall consider a joint credit obligation as an exposure to two or more obligors that are equally responsible for the repayment of the credit obligation. This notion does not extend to a credit obligation of an individual obligor secured by another individual or entity in the form of a guarantee or other credit protection.

102. Where the conditions of points (a) or (b) or both of Article 178(1) of the CRR are met with regard to a joint credit obligation of two or more obligors, credit institutions shall consider all other joint credit obligations of the same set of obligors and all individual exposures to those obligors as defaulted, unless they can justify that the recognition of default on individual exposures is not appropriate because at least one of the following conditions apply:

a. the delay in payment of a joint credit obligation results from a dispute between the individual obligors participating in the joint credit obligation that has been introduced to a court or another formal procedure performed by a dedicated external body that results in a binding ruling in accordance with the applicable legal framework in the relevant jurisdiction, and there is no concern about the financial situation of the individual obligors;

b. a joint credit obligation is an immaterial part of the total obligations of an individual obligor.

103. The default of a joint credit obligation shall not cause the default of other joint credit obligations of individual obligors with other individuals or entities, which are not involved in the credit obligation that has initially been defaulted; however, credit institutions shall assess whether the default of the joint credit obligation at hand constitutes an indication of unlikeliness to pay with regard to the other joint credit obligations.

104. Where the conditions of points (a) or (b) or both of Article 178(1) of the CRR are met with regard to the credit obligation of an individual obligor, the contagious effect of this default shall not automatically spread to any joint credit obligations of that obligor; nevertheless, credit institutions shall assess such joint credit obligations for possible indications of unlikeliness to pay related with the default of one of the obligors. In any case, where all individual obligors have a defaulted status, their joint credit obligation shall automatically also be considered defaulted.

105. Credit institutions shall identify and provide in their internal policies and procedures for the identification of the obligors that are legally fully liable for certain obligations jointly and severally with other obligors, therefore being fully liable for the entire amount of those obligations, but excluding credit obligations of an individual obligor secured by another individual or entity in the form of a guarantee or other credit protection. In the case of full mutual liability for all obligations, default of one of such obligors shall be considered an indication of potential unlikeliness to pay of the other obligor and therefore credit institutions shall assess whether the individual and joint credit obligations of these obligors shall be considered defaulted. Where one of the joint and several obligors that are legally fully liable for all obligations, has a joint credit obligation with another client, the credit institution shall assess whether

indications of unlikeliness to pay occur also on the other joint credit obligations with third parties.

106. Credit institutions shall also analyse the forms of legal entities and the extent of liability of the owners, partners, shareholders or managers for the obligations of a company depending on the legal form of the entity. Where an individual is fully liable for the obligations of a company, default of that company shall result in that individual being considered defaulted as well. Where such full liability for the obligations of a company does not exist, owners, partners or significant shareholders of a defaulted company shall be assessed by the credit institution for possible indications of unlikeliness to pay with regard to their individual obligations.

107. Additionally, in the specific case of an individual entrepreneur where an individual is fully liable for both private and commercial obligations with both private and commercial assets the default of any of the private or commercial obligations shall cause all private and commercial obligations of such individual to be considered as defaulted as well.

108. Where the definition of default is applied at the level of an obligor for retail exposures, the materiality threshold shall also be applied at the level of an obligor. Credit institutions shall clearly specify in their internal policies and procedures the treatment of joint credit obligations in the application of the materiality threshold.

109. A joint obligor, i.e. a specific set of individual obligors that have a joint obligation towards a credit institution, shall be treated as a different obligor from each of the individual obligors. In the case the delay in payment occurs on a joint credit obligation, the materiality of such delay shall be assessed by applying the materiality threshold referred to in paragraph 45 to all joint credit obligations granted to this specific set of obligors. For this purpose the individual exposures to obligors participating in a joint credit obligation or to any other subsets of such obligors shall not be taken into account. However, where the materiality threshold for a joint obligor calculated in this way is breached, all joint credit obligations of this set of obligors and all individual exposures to the obligors participating in a joint credit obligation shall be considered defaulted unless any of the conditions specified in paragraph 102 is met.

110. When delay in payment occurs on an individual credit obligation, the materiality of such delay shall be assessed by applying the materiality threshold referred to in paragraph 45 to all individual credit obligations of this obligor, without taking into account any joint credit obligations of that obligor with other individuals or entities. Where the materiality threshold calculated in this way is breached, all individual exposures to this obligor shall be considered defaulted.

2.6 Documentation, internal policies and risk management processes

2.6.1 Timeliness of the identification of default

111. Credit institutions shall have effective processes that allow them to obtain the relevant information in order to identify defaults in a timely manner, and to channel the relevant information in the shortest possible time and, where possible, in an automated manner, to the personnel that is rsponsible for taking credit decisions, and more in particular:
    a. where they apply automatic processes, such as counting of days past due, the identification of indications of default shall be performed on a daily basis;

    b. where they implement manual processes, such as checking external sources and databases, analysis of watch lists, analysis of the lists of forborne exposures, identification of SCRA, the information shall be updated with a frequency that guarantees the timely identification of default.

112. Credit institutions shall verify on a regular basis that all forborne non-performing exposures are classified as default and subject to distressed restructuring. Credit institutions shall also analyse on a regular basis the forborne performing exposures in order to determine whether any of them fulfils the indication of unlikeliness to pay as specified in Article 178(3)(d) of the CRR and in paragraphs 60 to 66.

113. Control mechanisms shall ensure that the relevant information is used in the default identification process immediately after being obtained. All exposures to a defaulted obligor or all relevant exposures in case of the application of the definition of default at the facility level for retail exposures shall be marked as defaulted in all relevant IT systems without undue delay. If delays occur in the recording of the default, such delays shall not lead to errors or inconsistencies in risk management, risk reporting, the own funds requirements calculation or the use of data in risk quantification. In

particular it shall be ensured that the internal and external reporting figures reflect a situation where all exposures are correctly classified.

2.6.2 Documentation

114. Credit institutions shall document their policies regarding the definition of default including all triggers for identification of default and the exit criteria as well as clear identification of the scope of application of the definition of default and, more in particular they shall:
    a. document the operationalisation of all indications of default;
    b. document the operationalisation of the criteria for reclassification of a defaulted obligor to a non-defaulted status;
    c. keep an updated register of all definitions of default.
115. For the purposes of point (a) of paragraph 114, credit institutions shall document the application of the definition of default in a detailed manner by including the operationalization of all indications of default, including the process, sources of information and responsibilities for the identification of particular indications of default.

116. For the purposes of point (b) of paragraph 114, credit institutions shall document the operationalization of the criteria for reclassification of a defaulted obligor to a non-defaulted status, including the processes, sources of information and responsibilities assigned to relevant personnel.

117. For the purposes of paragraphs 115 and 116, the documentation shall include description of all automatic mechanisms and manual processes, and where qualitative indications of default or criteria for the return to non-defaulted status are applied manually the description shall be sufficiently detailed to facilitate common understanding and consistent application by all responsible personnel.

118. For the purposes of point (c) of paragraph 114, credit institutions shall keep an updated register of all current and past versions of the default definition at least starting from the date of application of this Rule. This register shall include at least the following information:

a. the scope of application of the default definition, if there is more than one default definition used within the credit institution, the parent undertaking or any of its subsidiaries;

b. the body approving the definition or definitions of default and date of approval for each of those definitions of default;

c. the date of implementation of each definition of default;

d. brief description of all changes performed relatively to the last version.

PART 3: CREDIT RISK MANAGEMENT PRACTICES AND ACCOUNTING FOR EXPECTED CREDIT LOSSES

119. This Part of the Rule specifies sound credit risk management practices for credit institutions associated with the implementation and ongoing application of expected credit loss ('ECL') model implemented in accordance with IFRS 9.

120. This Part of the Rule applies in relation to those credit institutions' credit risk management practices affecting the assessment of credit risk and measurement of expected credit losses from lending exposures and allowances under the applicable accounting framework. This Part of the Rule also applies when, where permitted by the applicable accounting framework, the carrying amount of the lending exposure is reduced directly without the use of an allowance account. This Part of the Rule does not set out any additional requirements regarding the determination of expected loss for regulatory capital purposes.

121. This Part of the Rule builds on Article 74 of the CRD which states that credit institutions must have adequate internal control mechanisms, including sound administration and accounting procedures that are consistent with and promote sound and effective risk management; In addition, Article 88(1)(b) of the CRD states the principle that 'the management body must ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards'. Finally, as specified in Article 104(1) of the CRD, competent authorities may apply supervisory measures including requiring credit institutions to reinforce of the arrangements, processes, mechanisms and strategies implemented in accordance with Article 17C of the Act and 17B of the Act (Article 104(1)(b) of the CRD), the application of a specific provisioning policy or treatment of assets in terms of own funds requirements (Article 104(1)(d) of the CRD).

122. The paragraphs set out in Section 3.4 only apply in relation to credit institutions which prepare their financial statements in conformity with the International Financial Reporting Standards® ('IFRS® Standards') adopted in accordance with Regulation (CE) 1606/2002[6] and for which IFRS 9 *Financial Instruments* ('IFRS 9') applies.

[6] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards (OJ L 243, 11.9.2002, p. 1).

123. Credit institutions shall comply with this Part of the Rule on an individual, sub-consolidated and consolidated basis in accordance with Article 109 of the CRD.

3.1 Definitions

124. Unless otherwise specified, terms used and defined in the CRD, the CRR and IFRS 9 have the same meaning in this Part of the Rule. In addition, for the purposes of this Part, the following definitions apply:

"*allowances*" shall mean the stock of lending exposure loan loss provisions that has been recognized in the balance sheet of the credit institution, in accordance with the applicable accounting framework.

"*lending exposures*" shall mean loans, loan commitments and financial guarantee contracts to which an ECL framework applies.

"*temporary adjustments to an allowance*" shall mean adjustments to an allowance used to account for circumstances when it becomes evident that existing or expected risk factors have not been considered in the credit risk rating and modelling process as of the reporting date.

3.2 General provisions

3.2.1 Application of the principles of proportionality, materiality and symmetry

125. Credit institutions shall comply with this Part of the Rule in a manner that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities and portfolios, and, more generally, all other relevant facts and circumstances of the credit institution (and the group (if any) to which it belongs). The use of properly designed proportionate approaches shall not jeopardise the high-quality implementation of the ECL accounting frameworks.

126. Credit institutions shall also give due consideration to the application of the principle of materiality. However, this shall not result in individual exposures or portfolios being considered immaterial if, cumulatively, these represent a material exposure to the credit institution. In addition, materiality shall not be assessed only on the basis of the potential impact on the profit or loss statement at the reporting date. For instance,

large portfolio(s) of lending exposures such as real estate mortgages would generally be considered material even if they are highly collateralised.

127. In considering how to take proportionality or materiality into account in the design of an ECL methodology or in its implementation, it is important to ensure that bias is not being introduced.

128. The timely recognition of credit deterioration and allowances shall not be delayed without prejudice to the fact that ECL accounting frameworks are symmetrical in the way that subsequent changes (both deteriorations and reversals of those deteriorations) in the credit risk profile of a debtor shall be considered in the measurement of the allowances.

3.2.2 Consideration of reasonable and supportable information

129. Credit institutions shall consider a wide range of information when applying ECL accounting models. Information considered shall be relevant to the assessment of credit risk and measurement of ECL of the particular lending exposure being assessed, and shall include information about past events, current conditions and forecasts of future economic conditions. Information which is ultimately included in the assessment of credit risk and measurement of ECL shall also be reasonable and supportable. Credit institutions shall use their experienced credit judgement in determining the range of relevant information that shall be considered and in determining whether information is considered to be reasonable and supportable. Reasonable and supportable information shall be based on relevant facts and sound judgement.

3.2.3 Consideration of forward-looking information

130. In order to ensure a timely recognition of credit losses, credit institutions shall consider forward-looking information, including macroeconomic factors. When considering forward looking information, credit institutions shall apply sound judgement consistent with generally accepted methods for economic analysis and forecasting and supported by a sufficient set of data.

131. Credit institutions shall be able to demonstrate how they have considered relevant, reasonable and supportable information in the ECL assessment and measurement

process. Credit institutions shall apply experienced credit judgement in the consideration of future scenarios and take into account the potential consequence of events occurring or not occurring, and the resulting impact on the measurement of ECL. Information shall not be excluded from that process simply because an event has a low likelihood of occurring or the effect of that event on the credit risk or the amount of expected credit losses is uncertain. In certain circumstances information relevant to the assessment and measurement of credit risk may not be reasonable and supportable and shall therefore be excluded from the ECL assessment and measurement process. Given that these circumstances would be exceptional in nature, credit institutions shall provide a clearly documented, robust justification.

132. The information used shall include an unbiased consideration of relevant factors and their impact on creditworthiness and cash shortfalls. Relevant factors include those intrinsic to the credit institution and its business or derived from external conditions.

3.3 Principles on credit risk management practices and accounting for expected credit losses

3.3.1 Principle 1 — Responsibilities of the Board of Directors and Senior Management

133. The board of directors and senior management of a credit institution shall be responsible for ensuring that the credit institution has appropriate credit risk management practices, including an effective internal control system, to consistently determine adequate allowances in accordance with the credit institution's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

134. The credit institution's board of directors shall be responsible for approving and regularly reviewing a credit institution's credit risk management strategy and the main policies and processes for identifying, measuring, evaluating, monitoring, reporting and mitigating credit risk consistent with the approved risk appetite set by the board of directors. In addition, to limit the risk that lending exposures pose to depositors and, more generally, financial stability, a credit institution's board of directors shall require that senior management adopt and adhere to sound underwriting practices[7].

[7] The Financial Stability Board published Principles for sound residential mortgage underwriting practices in April 2012, which aim to provide a framework for jurisdictions to set minimum acceptable

135. To fulfil these responsibilities, the board of directors shall instruct senior management to:
    a. develop and maintain appropriate processes, which shall be systematic and consistently applied, to determine appropriate allowances in accordance with the applicable accounting framework;

    b. establish and implement an effective internal control system for credit risk assessment and measurement; report periodically the results of the credit risk assessment and measurement processes, including estimates of its ECL allowances;

    c. establish, implement and, as necessary, update suitable policies and procedures to communicate the credit risk assessment and measurement process internally to all relevant staff, in particular staff members who are involved in that process.

    Senior management shall be responsible for implementing the credit risk strategy approved by the board of directors and developing the aforementioned policies and processes.

136. An effective internal control system for credit risk assessment and measurement shall include:
    a. measures to comply with applicable laws, regulations, internal policies and procedures;

    b. measures to provide oversight of the integrity of information used and reasonably ensure that the allowances reflected in the credit institution’s financial statements and reports submitted to the Authority are prepared in accordance with the applicable accounting framework and relevant supervisory requirements;

underwriting standards for real estate lending exposures; available at www.financialstabilityboard.org/publications/r_120418.pdf. The EBA has published Guidelines on creditworthiness assessment (EBA/GL/2015/11) which are aligned with the FSB Principles and cover some of them.

c. well-defined credit risk assessment and measurement processes that are independent from (while taking appropriate account of) the lending function, which contain:

i. an effective credit risk rating system that is consistently applied, accurately grades differentiating by credit risk characteristics, identifies changes in credit risk on a timely basis, and prompts appropriate action;

ii. an effective process to ensure that all relevant and reasonable and supportable information, including forward-looking information, is appropriately considered in assessing credit risk and measuring ECL. This includes maintaining appropriate reports, details of reviews performed, and identification and descriptions of the roles and responsibilities of staff involved;

iii. an assessment policy that ensures ECL measurement occurs at the individual lending exposure level and also, when necessary to appropriately measure ECL in accordance with the applicable accounting framework, at the collective portfolio level by grouping exposures based on identified shared credit risk characteristics;

iv. an effective model validation process to ensure that the credit risk assessment and measurement models are able to generate accurate, consistent and unbiased predictive estimates, on an ongoing basis. This includes establishing policies and procedures which set out the accountability and reporting structure of the model validation process, internal rules for assessing and approving changes to the models, and reporting of the outcome of the model validation;

v. clear formal communication and coordination among a credit institution's credit risk staff, financial reporting staff, senior management, the board of directors and others who are involved in the credit risk assessment and ECL measurement process. This shall be evidenced by written policies and procedures, management reports and minutes of committees involved such as board of directors or senior management committees; and

d. an internal audit function that:

i. independently evaluates the effectiveness of the credit institution's credit risk assessment and measurement systems and processes, including the credit risk rating system; and

ii. makes recommendations on addressing any weaknesses identified during this evaluation.

3.3.2 Principle 2 — Sound ECL methodologies

137. Credit institutions shall adopt, document and adhere to policies which include sound methodologies, procedures and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances shall build upon those methodologies and result in the appropriate and timely recognition of ECL in accordance with the applicable accounting framework.

138. The credit risk assessment and measurement process shall provide the relevant information for senior management to make its experienced judgements about the credit risk of lending exposures, and the related estimation of ECL.

139. Credit institutions shall, to the maximum extent possible, leverage and integrate common processes, systems, tools and data that are used within a credit institution to determine if, when, and on what terms, credit shall be granted; monitor credit risk; and measure allowances for both accounting and capital adequacy purposes.

140. A credit institution's allowance methodologies shall clearly document the definitions of key terms related to the assessment of credit risk and ECL measurement (such as loss and migration rates, loss events and default). Where different terms, information or assumptions are used across functional areas (such as accounting, capital adequacy and credit risk management), the underlying rationale for these differences shall be documented and approved by senior management. Information and assumptions used for ECL estimates shall be reviewed and updated as required by the applicable accounting framework.

141. Credit institutions shall have in place adequate processes and systems to appropriately identify, measure, evaluate, monitor, report and mitigate the level of credit risk.

142. Credit institutions shall adopt and adhere to written policies and procedures detailing the credit risk systems and controls used in their credit risk methodologies, and the separate roles and responsibilities of the credit institution's board of directors and senior management.

143. Sound methodologies for assessing credit risk and measuring the level of allowances (subject to exposure type, for example retail or wholesale) shall, in particular:

   a. include a robust process that is designed to equip the credit institution with the ability to identify the level, nature and drivers of credit risk upon initial recognition of the lending exposure, to ensure that subsequent changes in credit risk can be identified and quantified;

   b. include criteria to duly consider the impact of forward-looking information, including macroeconomic factors. Whether the evaluation of credit risk is conducted on a collective or individual basis, a credit institution shall be able to demonstrate that this consideration has occurred so that the recognition of ECL is not delayed. Such criteria shall result in the identification of factors that affect repayment, whether related to borrower incentives, willingness or ability to perform on the contractual obligations, or lending exposure terms and conditions. Economic factors considered (such as unemployment rates or occupancy rates) shall be relevant to the assessment and, depending on the circumstances, this may be at the international, national, regional or local level;

   c. include, for collectively evaluated exposures, a description of the basis for creating groups of portfolios of exposures with shared credit risk characteristics;

   d. identify and document the ECL assessment and measurement methods (such as a loss rate method, probability of default (PD)/loss-given-default (LGD) method, or another method) to be applied to each exposure or portfolio;

   e. document the reasons why the selected method is appropriate, especially if different ECL measurement methods are applied to different portfolios and types of individual exposures. Credit institutions shall be able to explain to the Authority the rationale for any changes in measurement approach (for example, a move

from a loss rate method to a PD/LGD method) and the quantitative impacts of such changes;

f. document:

   i. the inputs, data and assumptions used in the allowance estimation process, such as historical loss rates, PD/LGD estimates and economic forecasts;

   ii. how the life of an exposure or portfolio is determined (including how expected prepayments and defaults have been considered);

   iii. the time period over which historical loss experience is evaluated;

   iv. any adjustments necessary for the estimation of ECL in accordance with the applicable accounting framework. For example, if current and forecasted economic conditions are different from those that existed during the historical estimation period being used, adjustments that are directionally consistent with those differences shall be made. In addition, a credit institution may have experienced little to no actual losses in the historical period analysed; however, current or forward-looking conditions can differ from conditions during the historical period, and the impact of these changes on ECL shall be assessed and measured;

g. include a process for evaluating the appropriateness of significant inputs and assumptions in the ECL measurement method chosen. The basis for inputs and assumptions used in the process of the estimation of allowances shall generally be consistent from period to period. Where the inputs and assumptions or the basis for these change, the rationale shall be documented;

h. identify the situations that would generally lead to changes in ECL measurement methods, inputs or assumptions from period to period (for example, a credit institution may state that a loan that had been previously evaluated on a collective basis using a PD/LGD method may be removed and evaluated individually using

the discounted cash flow method upon receipt of new, borrower-specific information such as the loss of employment);

i. consider the relevant internal and external factors that may affect ECL estimates, such as the underwriting standards applied to a lending exposure at origination and changes in industry, geographical, economic and political factors;

j. address how ECL estimates are determined (for example historical loss rates or migration analysis as a starting point, adjusted for information on current and expected conditions). A credit institution shall have an unbiased view of the uncertainty and risks in its lending activities when estimating ECL;

k. identify what factors are considered when establishing appropriate historical time periods over which to evaluate historical loss experience. A credit institution shall maintain sufficient historical loss data to provide a meaningful analysis of its credit loss experience for use as a starting point when estimating the level of allowances on a collective or individual basis;

l. determine the extent to which the value of collateral and other credit risk mitigants affects ECL;

m. outline the credit institution's policies and procedures on write-offs and recoveries;

n. require that analyses, estimates, reviews and other tasks/processes that are inputs to or outputs from the credit risk assessment and measurement process are performed by competent and well-trained staff and validated by staff who are independent of the credit institution's lending activities. These inputs to and outputs from these functions shall be well documented, and the documentation shall include clear explanations supporting the analyses, estimates and reviews;

o. document the methods used to validate models for ECL measurement (for example backtests);

p. ensure that ECL estimates appropriately incorporate forward-looking information, including macroeconomic factors, that has not already been factored into allowances measured on an individual exposure basis. This may require management to use its experienced credit judgement to consider broad trends in the entire lending portfolio, changes in the credit institution's business model, macroeconomic factors, etc.; and

q. require a process to assess the overall appropriateness of allowances in accordance with the relevant accounting framework, including a regular review of ECL models.

144. A credit institution's credit risk identification process shall ensure that factors that impact changes in credit risk and estimates of ECL are properly identified on a regular basis. In addition, consideration of credit risk inherent in new products and activities shall be a key part of the credit risk identification process, the assessment of credit risk and measurement of ECL.

145. Senior management shall consider relevant facts and circumstances, including forward looking information, that are likely to cause ECL to differ from historical experience and that may affect credit risk and the full collectability of cash flows.

146. With respect to factors related to the character, capacity and capital of borrowers, the terms of lending exposures, and the values of assets pledged as collateral together with other credit risk mitigants that may affect the full collectability of cash flows, a credit institution shall (depending on the type of exposure) consider:

a. its lending policies and procedures, including its underwriting standards and lending terms, that were in effect upon initial recognition of the borrower's lending exposure, and whether the lending exposure was originated as an exception to this policy. A credit institution's lending policy shall include details of its underwriting standards, and guidelines and procedures that drive the credit institution's lending approval process;

b. a borrower's sources of recurring income available to meet the scheduled payments;

c. a borrower's ability to generate a sufficient cash flow stream over the term of the financial instrument;

d. the borrower's overall leverage level and expectations of changes to leverage;

e. the incentives or willingness of borrowers to meet their obligations;

f. unencumbered assets the borrower may pledge as collateral in the market or bilaterally in order to raise funds and expectations of changes to the value of those assets;

g. reasonably possible one-off events and recurring behaviour that may affect the borrower's ability to meet contractual obligations; and

h. timely evaluations of collateral value and consideration of factors that may impact the future value of collateral (bearing in mind that collateral values directly affect estimates of LGD).

147. Where they have the potential to affect the credit institution's ability to recover amounts due, credit institutions shall consider factors relating to the credit institution's business model and current and forecasted macroeconomic conditions, including but not limited to:

a. competition and legal and regulatory requirements;

b. trends in the credit institution's overall volume of credit;

c. the overall credit risk profile of the credit institution's lending exposures and expectations of changes thereto;

d. credit concentrations to borrowers or by product type, segment or geographical market;

e. expectations of collection, write-off and recovery practices;

f. the quality of the credit institution's credit risk review system and the degree of oversight by the credit institution's senior management and board of directors; and

g. other factors that may impact ECL including, but not limited to, expectations of changes in unemployment rates, gross domestic product, benchmark interest rates, inflation, liquidity conditions, or technology.

148. Sound credit risk methodologies shall consider different potential scenarios and shall not rely purely on subjective, biased or overly optimistic considerations. Credit institutions shall develop and document their processes to generate relevant scenarios to be used in the estimation of ECL. In particular:

  a. credit institutions shall demonstrate and document how ECL estimates would alter with changes in scenarios, including changes to relevant external conditions that may impact ECL estimates or components of the ECL calculation (such as PD and LGD parameters);

  b. credit institutions shall have a documented process for determining the time horizon of the scenarios and, if relevant, how ECL is estimated for exposures whose lives exceed the period covered by the economic forecast(s) used;

  c. scenarios may be internally developed or outsourced. For internally developed scenarios, credit institutions shall have a variety of experts, such as risk experts, economists, business managers and senior management, assisting in the selection of scenarios that are relevant to the credit institutions' credit risk exposure profile. For outsourced scenarios, credit institutions shall ensure that the external provider tailors the scenarios to reflect the credit institutions' business and credit risk exposure profile, as credit institutions remain responsible for those scenarios;

  d. backtesting shall be performed to ensure that the most relevant economic factors that affect collectability and credit risk are being considered and incorporated into ECL estimates; and

  e. where market indicators (such as credit default swaps ('CDS') spreads) are available, senior management may consider them to be a valid benchmark against which to check the consistency of its own judgements.

149. While a credit institution does not need to identify or model every possible scenario through scenario simulations, it shall consider all reasonable and supportable information that is relevant to the product, borrower, business model or economic

and regulatory environment when developing estimates of ECL. In developing such estimates for financial reporting purposes, credit institutions shall consider the experience and lessons from similar exercises it has conducted for regulatory purposes (although stressed scenarios are not intended to be used directly for accounting purposes). Forward-looking information, including economic forecasts and related credit risk factors used for ECL estimates, shall be consistent with inputs to other relevant estimates within the financial statements, budgets, strategic and capital plans, and other information used in managing and reporting within a credit institution.

150. Senior management shall be able to demonstrate that it understands and appropriately considers inherent risks when pricing lending exposures. Credit institutions shall take particular care of the following fact patterns, which are potentially indicative of inadequate estimates of ECL:

a. the granting of credit to borrowers based on fragile income streams (that could become nonrecurrent upon a downturn) or with no documentation or limited verification of borrower income sources;

b. high debt service requirements relative to the borrower's net available expected cash flows;

c. flexible repayment schedules, including payment vacations, interest-only payments and negative amortisation features;

d. for real estate and other asset based financing, lending of amounts equal to or exceeding the value of the financed property or otherwise failing to provide an adequate margin of collateral protection;

e. undue increases in modifications of lending exposures due to financial difficulties faced by the borrower or renegotiations/modifications of lending exposures for other reasons (such as competitive pressures faced by credit institutions);

f. circumvention of the classification and rating requirements, including rescheduling, refinancing or reclassification of lending exposures;

g. undue increases in the volume of credit, especially in relation to the increase in the volume of credit by other lenders in the same market; and

h. increasing volume and severity of past-due, low-quality and impaired credit.

151. Credit institutions' accounting policies shall address, and their allowance methodology shall include, criteria for (a) renegotiations/modifications of lending exposures due to financial difficulties or for other reasons, considering also the specific definitions of forbearance established in Part 2 of Annex V of Commission Implementing Regulation (EU) 451/2021 and (b) the treatment of purchased or originated credit-impaired lending exposures as defined under the applicable accounting framework:

a. Credit institutions shall take into account the following criteria regarding renegotiations/modifications of lending exposures:

i. The allowance methodology shall enable credit institutions to perform a robust assessment of credit risk and measurement of ECL such that the allowance level continues to reflect the collectability of the substance of the renegotiated/modified exposure, irrespective of whether or not the original asset is derecognised under the applicable accounting framework.

ii. Renegotiations/modifications shall not automatically lead to the conclusion that there has been an immediate decrease in the credit risk of the exposure. Any decrease in the reported allowance level due to improved credit risk shall be supported by strong evidence. Customers shall demonstrate consistently satisfactory payment performance over a reasonable period of time before credit risk would be considered to have decreased, considering also the relevant requirements for exposures in the probation period as defined in Part 2 of Annex V of Commission Implementing Regulation (EU) 451/2021.

iii. Credit institutions shall carefully consider whether the collection of loan principal is reasonably assured when repayment performance takes the form of interest payments alone, subsequent to a renegotiation or modification. In addition, further expected delays in the payment of those cash flows may evidence that credit risk has not improved, and thus the level of ECL shall be reassessed carefully.

iv. The methodologies shall also call upon the lending staff to promptly notify the institution's accounting function when exposures are renegotiated or

modified to ensure appropriate accounting for the change. For more complex renegotiations and modifications, regular communication between the lending staff and the accounting function shall take place.

b. Credit institutions shall take into account the following criteria regarding purchased or originated credit-impaired lending exposures:

i. The methodology shall enable appropriate identification and accounting for purchased or originated credit-impaired lending.

ii. The cash flow estimates for these lending exposures shall be reviewed each reporting period and updated as necessary. Such updates shall be properly supported and documented, and approved by senior management.

3.3.3 Principle 3 — Credit risk rating process and grouping

152. Credit institutions shall have a credit risk rating process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.

3.3.3.1 Credit risk rating process

153. As part of its credit risk assessment process, credit institutions shall have in place comprehensive procedures and information systems to monitor the quality of their lending exposures. These include an effective credit risk rating process that captures the varying level, nature and drivers of credit risk that may manifest themselves over time, in order to reasonably ensure that all lending exposures are properly monitored and that ECL allowances are appropriately measured.

154. The credit risk rating process shall include an independent review function. Initial assignment of credit risk grades to exposures and their ongoing updating by front-line lending staff shall be subject to the review of the independent review function.

155. Credit institutions shall take into account a number of criteria when assigning the credit risk grade upon initial recognition of a lending exposure including, to the extent relevant, product type, terms and conditions, collateral type and amount, borrower characteristics and geography or a combination thereof.

156. When changing existing credit risk grades assigned, on either a portfolio or an individual basis, credit institutions shall take into account other relevant factors such as, but not limited to, changes in industry outlook, business growth rates, consumer sentiment and changes in economic forecasts (such as interest rates, unemployment rates and commodity prices) as well as weaknesses in underwriting identified after initial recognition.

157. The credit risk rating system shall capture all lending exposures when assessing the impact of changes in credit risk, and not only those that may have experienced significant increases in credit risk, have incurred losses or are otherwise credit impaired. This is to allow for an appropriate differentiation of credit risk and grouping of lending exposures within the credit risk rating system, and to reflect the risk of individual exposures as well as, when aggregated across all exposures, the level of credit risk in the portfolio as a whole. In this context, an effective credit risk rating system shall allow credit institutions to identify both migration of credit risk and significant changes in credit risk.

158. Credit institutions shall describe the elements of their credit risk rating system, clearly defining each credit risk grade and designating the staff responsible for the design, implementation, operation and performance of the system as well as those responsible for periodic testing and validation (i.e. the independent review function).

159. Credit institutions shall review risk grades whenever relevant new information is received or a credit institution's expectation of credit risk has changed. Credit risk grades assigned shall receive a periodic formal review (for example at least annually, or more frequently if required in a jurisdiction) to reasonably ensure that those grades are accurate and up to date. Credit risk grades for individually assessed lending exposures that are higher risk or credit impaired shall be reviewed more frequently than annually. ECL estimates shall be updated on a timely basis to reflect changes in credit risk grades for either groups of exposures or individual exposures.

3.3.3.2 Grouping based on shared credit risk characteristics

160. Credit institutions shall group exposures with shared credit risk characteristics in a way that is sufficiently granular to be able to reasonably assess changes in credit risk and thus the impact on the estimate of ECL for these groups.

161. A credit institution's methodology for grouping exposures to assess credit risk (such as by instrument type, product terms and conditions, industry/market segment, geographical location or vintages) shall be documented and subject to appropriate review and internal approval by senior management.

162. Lending exposures shall be grouped according to shared credit risk characteristics so that changes in the level of credit risk respond to the impact of changing conditions on a common range of credit risk drivers. This includes considering the effect on the group's credit risk in response to changes in forward-looking information, including macroeconomic factors. The basis of grouping shall be reviewed by senior management to ensure that exposures within the group remain homogeneous in terms of their response to credit risk drivers and that the relevant credit risk characteristics and their impact on the level of credit risk for the group have not changed over time.

163. Exposures shall not be grouped in such a way that an increase in the credit risk of particular exposures is obscured by the performance of the group as a whole.

164. Credit institutions shall have in place a robust process to ensure appropriate initial grouping of their lending exposures. Subsequently, the grouping of exposures shall be re-evaluated and exposures shall be re-segmented if relevant new information is received or a credit institution's changed expectations of credit risk suggest that a permanent adjustment is warranted. If a credit institution is not able to re-segment exposures on a timely basis, a temporary adjustment shall be used.

3.3.3.3 Use of temporary adjustments

165. Credit institutions shall use temporary adjustments to an allowance only as an interim solution, in particular in transient circumstances or when there is insufficient time to appropriately incorporate relevant new information into the existing credit risk rating and modelling process, or to re-segment existing groups of lending exposures, or when lending exposures within a group of lending exposures react to factors or events differently than initially expected.

166. Such adjustments shall not be continuously used over the long term for a non-transient risk factor. If the reason for the adjustment is not expected to be temporary, such as the emergence of a new risk driver that has not previously been incorporated

into the institution's allowance methodology, the methodology shall be updated in the near term to incorporate the factor that is expected to have an ongoing impact on the measurement of ECL.

167. The use of temporary adjustments requires the application of significant judgement and creates the potential for bias. In order to avoid the creation of potential for bias, temporary adjustments shall be directionally consistent with forward-looking forecasts, supported by appropriate documentation, and subject to appropriate governance processes.

3.3.4 Principle 4 — Adequacy of the allowance

168. A credit institution's aggregate amount of allowances, regardless of whether allowances are determined on a collective or an individual basis, shall be adequate and consistent with the objectives of the applicable accounting framework.

169. Credit institutions shall implement sound credit risk methodologies with the objective that the overall balance of the allowance for ECL is developed in accordance with the applicable accounting framework and adequately reflects ECL within that framework.

170. When assessing the adequacy of the allowances credit institutions shall take into account relevant factors and expectations at the reporting date that may affect the collectability of remaining cash flows over the life of a group of lending exposures or a single lending exposure. Credit institutions shall consider information which goes beyond historical and current data, and take into account reasonable and supportable forward-looking information, including macroeconomic factors, that are relevant to the exposure(s) being evaluated (for example retail or wholesale) in accordance with the applicable accounting framework.

171. Depending on the ability to incorporate forward-looking information into the ECL estimate, credit institutions may use individual or collective assessment approaches; regardless of the assessment approach used, they shall be consistent with the relevant accounting requirements and not result in materially different allowance measurements. Together, individual and collective assessments form the basis for the allowance for ECL.

172. The ECL assessment approach used shall be the most appropriate in the particular circumstances, and typically shall be aligned with how the credit institution manages the lending exposure. For example, collective assessment is often used for large groups of homogeneous lending exposures with shared credit risk characteristics, such as retail portfolios. Individual assessments are often conducted for significant exposures, or where credit concerns have been identified at the individual loan level, such as watch list and past due loans.

173. Regardless of the assessment approach it uses (individual or collective), a credit institution shall ensure this does not result in delayed recognition of ECL.

174. When credit institutions use individual assessments, the ECL estimate shall always incorporate the expected impact of all reasonable and supportable forward-looking information, including macroeconomic factors, that affect collectability and credit risk. When applying an individual assessment approach, in the same manner as in the case of collective assessment, the credit institution's documentation shall clearly demonstrate how forward-looking information, including macroeconomic factors, has been reflected in the individual assessment.

175. In cases when a credit institution's individual assessments of exposures do not adequately consider forward-looking information, and in order to allow identification of relationships between forward-looking information and ECL estimates that may not be apparent at the individual level, an institution shall group lending exposures with shared credit risk characteristics to estimate the impact of forward-looking information, including macroeconomic factors. Conversely, when credit institutions determine that all reasonable and supportable forward-looking information has been incorporated in the individual assessment of ECL, an additional forward-looking assessment shall not be conducted on a collective basis if that could result in double counting.

3.3.5 Principle 5 — ECL model validation

176. A credit institution shall have policies and procedures in place to appropriately validate models used to measure ECL.

177. Credit institutions may use in the ECL assessment and measurement process models and assumption-based estimates for risk identification and measurement, at both the

individual lending exposure and overall portfolio levels, including credit grading, credit risk identification, measurement of ECL allowances for accounting purposes, stress testing and capital allocation. Models used in the ECL assessment and measurement process shall consider the impact of changes to borrower and credit risk-related variables such as changes in PDs, LGDs, exposure amounts, collateral values, migration of default probabilities and internal borrower credit risk grades based on historical, current, and reasonable and supportable forward-looking information, including macroeconomic factors.

178. Credit institutions shall have robust policies and procedures in place to appropriately validate the accuracy and consistency of the models used to assess the credit risk and measure ECL, including their model-based credit risk rating systems and processes and the estimation of all relevant risk components, at the outset of model usage and on an ongoing basis. Such policies and procedures shall appropriately include the role of professional judgement.

179. Model validation shall be conducted when the ECL models are initially developed and when significant changes are made to the models, and shall ensure that the models are suitable for their proposed usage on an ongoing basis.

180. A sound model validation framework shall include, but not be limited to, the following elements:
    a. Clear roles and responsibilities for model validation with adequate independence and competence. Model validation shall be performed independently of the model development process and by staff with the necessary experience and expertise. The findings and outcomes of model validation shall be reported in a prompt and timely manner to the appropriate level of authority. Where a credit institution has outsourced its validation function to an external party, the credit institution remains responsible for the effectiveness of all model validation work and shall ensure that the work done by the external party meets the elements of a sound model validation framework on an ongoing basis.

    b. An appropriate model validation scope and methodology shall include a systematic process of evaluating the model's robustness, consistency and accuracy as well as its continued relevance to the underlying individual lending exposure or portfolio. An effective model validation process shall also enable

potential limitations of a model to be identified and addressed on a timely basis. The scope for validation shall include a review of model inputs, model design and model outputs/performance.

i. *Model inputs:* Credit institutions shall have internally established quality and reliability standards on data (historical, current and forward-looking information) used as model inputs. Data used to estimate ECL allowances shall be relevant to the credit institutions' portfolios and, as far as possible, accurate, reliable and complete (i.e. without exclusions that could bias ECL estimates). Validation shall ensure that the data used meet these standards.

ii. *Model design:* For model design, validation shall assess that the underlying theory of the model is conceptually sound, recognised and generally accepted for its intended purpose. From a forward-looking perspective, validation shall also assess the extent to which the model, at the overall model and individual risk factor level, can take into consideration changes in the economic or credit environment, as well as changes to portfolio business profile or strategy, without significantly reducing model robustness.

iii. *Model output/performance:* Credit institutions shall have internally established standards for acceptable model performance. Where performance thresholds are significantly breached, remedial actions up to the extent of model re-calibration or redevelopment shall be taken.

c. Comprehensive documentation of the model validation framework and process. This shall include documenting the validation procedures performed, any changes in validation methodology and tools, the range of data used, validation results and any remedial actions taken where necessary. Credit institutions shall ensure that the documentation is regularly reviewed and updated.

d. A review of the model validation process by independent parties (e.g. internal or external parties) to evaluate the overall effectiveness of the model validation process and the independence of the model validation process from the development process. The findings of the review shall be reported in a prompt and timely manner to the appropriate level of authority (e.g. senior management, audit committee).

3.3.6 Principle 6 — Experienced credit judgement

181. A credit institution's use of experienced credit judgement, especially in the consideration of reasonable and supportable forward-looking information, including macroeconomic factors, is essential to the assessment of credit risk and measurement of ECL.

182. Credit institutions shall have the necessary tools to ensure a robust estimate and timely recognition of ECL. Given that information on historical loss experience or the impact of current conditions may not fully reflect the credit risk in lending exposures, credit institutions shall use their experienced credit judgement to thoroughly incorporate the expected impact of all reasonable and supportable forward-looking information, including macroeconomic factors, on its estimate of ECL. A credit institution's use of its experienced credit judgement shall be documented in the credit institution's credit risk methodology and subject to appropriate oversight.

183. Historical information provides a useful basis for the identification of trends and correlations needed to identify the credit risk drivers for lending exposures. However, ECL estimates must not ignore the impact of (forward-looking) events and conditions on those drivers. The estimate shall reflect the expected future cash shortfalls resulting from such impact.

184. Consideration of forward-looking information shall not be avoided on the basis that a credit institution considers the cost of incorporating such forward-looking information to be very high or unnecessary or because there is uncertainty in formulating forward-looking scenarios, unless the additional cost and operational burden to be introduced do not contribute to a high-quality implementation of an ECL accounting framework.

185. Credit institutions shall be able to demonstrate that the forward-looking information factored into the ECL estimation process has a link to the credit risk drivers for particular exposures or portfolios. Given that it may not be possible to demonstrate a strong link in formal statistical terms between certain types of information, or even the information set as a whole, and the credit risk drivers, credit institutions shall use their experienced credit judgement in establishing an appropriate level for the individual or collective allowance. When a forward-looking factor that has been

identified as relevant is not incorporated into the individual or collective assessment, temporary adjustments may be necessary.

186. Macroeconomic forecasts and other relevant information shall be applied consistently across portfolios where the credit risk drivers of the portfolios are affected by these forecasts/assumptions in the same way. Furthermore, when developing ECL estimates, credit institutions shall apply their experienced credit judgement to consider their point in the credit cycle, which may differ across the jurisdictions in which they have lending exposures.

187. Credit institutions shall exercise care when determining the level of ECL allowances to be recognised for accounting purposes, to ensure that the resulting estimates are appropriate (i.e. consistent with neutrality and neither understated nor overstated).

188. Additionally, credit institutions shall avail themselves of a wide range of information derived in the credit risk management process, including that of a forward-looking nature for risk management and capital adequacy purposes, in developing their estimate of ECL.

3.3.7 Principle 7 — Common processes, systems, tools and data

189. Credit institutions shall have a sound credit risk assessment and measurement process that provides them with a strong basis for common processes, systems, tools and data to assess credit risk and to account for expected credit losses.

190. To the maximum extent possible, credit institutions shall use common processes, systems, tools and data to assess credit risk, measure ECL for accounting purposes and determine expected losses for capital adequacy purposes in order to strengthen the reliability and consistency of the resulting ECL estimates, increase transparency and, through market discipline, provide incentives to follow sound credit risk practices.

191. Credit risk practices shall be reviewed periodically to ensure that relevant data available throughout a credit institution's organisation are captured and that systems are updated as the credit institution's underwriting or business practices change or evolve over time. A feedback loop shall be established to ensure that information on estimates of ECL, changes in credit risk and actual losses experienced on lending

exposures is shared among credit risk experts, accounting and regulatory reporting staff, and in particular with the loan underwriting staff.

192. The common processes, systems, tools and data mentioned above could include credit risk rating systems, estimated PDs (subject to appropriate adjustments), past-due status, loan-to-value ratios, historical loss rates, product type, amortisation schedule, down payment requirements, market segment, geographical location, vintage (i.e. date of origination) and collateral type.

3.3.8 Principle 8 — Disclosure

193. A credit institution’s public disclosures shall promote transparency and comparability by providing timely, relevant and decision-useful information.

194. The objective of public disclosures is to provide decision-useful information on a credit institution’s financial position and performance, and changes therein, to a wide range of users in a clear and understandable manner. Credit institutions shall provide information that is relevant and comparable so that users can make timely, informed decisions and are able to evaluate the stewardship of management body and senior management.

195. Financial and credit risk management disclosures shall be made in accordance with the applicable accounting and supervisory frameworks[8]. Credit institutions shall provide the disclosures needed to fairly depict a credit institutions’ exposure to credit risk, including its ECL estimates, and to provide relevant information on a credit institution’s underwriting practices.

196. Consistently with the applicable accounting standards and regulations, credit institutions’ senior management shall apply judgement to determine the appropriate level of aggregation and disaggregation of data disclosed, such that disclosures continue to meet accounting requirements, and provide insights into a credit

[8] In accordance with Part 8 of the CRR, Commission Implementing Regulation 2021/637 laying down implementing technical standards with regard to public disclosures by institutions of the information referred to in Titles II and III of Part Eight of Regulation (EU) No 575/2013, and EBA GL/2014/14 on materiality, proprietary and confidentiality and on disclosure frequency under Articles 432(1), 432(2) and 433 of the CRR.

institution’s exposure to credit risk and ECLs for users to perform individual institution analysis and relevant peer group comparisons.

197. Quantitative and qualitative disclosures when taken as a whole shall communicate to users the main assumptions/inputs used to develop ECL estimates. Disclosures shall highlight policies and definitions that are integral to the estimation of ECL (such as a credit institution’s basis for grouping lending exposures into portfolios with similar credit risk characteristics and its definition of default[9]), factors that cause changes in ECL estimates, and the manner in which senior management’s experienced credit judgement has been incorporated. Disclosure of significant policies shall indicate how those policies have been implemented in the specific context of the credit institution.

198. Credit institutions shall provide qualitative disclosures on how forward-looking information, including macroeconomic factors, has been incorporated into the ECL estimation process, in accordance with the applicable accounting framework, in particular when the assessment is carried out on an individual basis.

199. Disclosures regarding the basis for grouping lending exposures shall include information on how senior management satisfies itself that lending exposures are appropriately grouped, such that these groups continue to share credit risk characteristics.

200. To improve the quality and meaningfulness of information disclosed for ECL estimates, credit institutions shall provide an explanation of significant changes to the estimation of ECL from period to period. This information shall include both relevant qualitative and quantitative disclosures in a manner that enhances the understanding of how ECL estimates have changed.

201. Credit institutions’ board of directors shall regularly review its disclosure policies to ensure that the information disclosed continues to be relevant to the credit institution’s risk profile, product concentrations, industry norms and current market conditions. In doing so, credit institutions shall provide disclosures that facilitate comparisons with its peers, enabling users to monitor changes in the credit institution’s ECL estimates from period to period and perform meaningful analyses across national and international peer groups.

[9] See paragraphs 206 and 207 in the next section for further guidance on definition of default.

3.4 Specific rules to credit institutions applying IFRS 9

202. This section provides the applicable rules on aspects of the ECL requirements in the impairment sections of IFRS 9 — (i) the loss allowance at an amount equal to 12-month ECL; (ii) the assessment of significant increases in credit risk; and (iii) the use of practical expedients — that are not common to other ECL accounting frameworks and shall be read in conjunction with the other sections of this Rule.

3.4.1 Loss allowance at an amount equal to 12-month ECL

203. In accordance with paragraph 5.5.5 of IFRS 9, 'if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses'. Credit institutions shall measure ECL for all lending exposures and a nil allowance shall be rare because ECL estimates are a probability-weighted amount that shall always reflect the possibility that a credit loss will occur (see paragraphs 5.5.17 and 5.5.18 of IFRS 9). A nil allowance could however occur, for example, for fully collateralised loans (although credit institutions shall be cautious when developing estimates of collateral value, as valuation of collateral at origination may change over the life of the loan).

204. Credit institutions shall adopt an active approach to assessing and measuring 12-month ECL that enables changes in credit risk to be identified in a timely manner and hence the timely recognition of those changes in ECL. In accordance with Principle 6, estimates of the amount and timing of 12-month ECL shall reflect senior management's experienced credit judgement, and represent an unbiased probability-weighted estimate of ECL by considering a range of possible outcomes.

205. IFRS 9 defines an amount equal to 12-month ECL as 'the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date'[10]. For these purposes, credit institutions must note that an amount equal to the 12-month ECL is not only the losses expected in the next 12 months; rather, in accordance with IFRS 9, paragraph B5.5.43, it is the expected cash shortfalls over the life of the lending exposure or group of lending exposures, due to loss events that could occur in the next 12 months. Credit institutions must also note that, in

[10] See IFRS 9, Appendix A, Defined terms.

accordance with IFRS 9, paragraph 5.5.9, to assess whether a financial instrument shall move to a lifetime ECL measure, the change in the risk of a default occurring over the expected life of the financial instrument must be considered. In some circumstances, IFRS 9 allows changes in the risk of a default occurring over the next 12 months to be used to make this assessment; however, this may not always be appropriate, and particular attention shall be given to the examples set out in IFRS 9, paragraph B5.5.14.

206.IFRS 9, paragraph B5.5.37, does not define default, but requires credit institutions to define default in a manner consistent with that used for internal credit risk management. IFRS 9, paragraph B5.5.37, also includes a rebuttable presumption that default does not occur later than 90 days past due. When adopting a definition of default for accounting purposes, credit institutions shall be guided by the definition used for regulatory purposes provided in Article 178 of the CRR and Part 2 of this Rule, which includes both:

a. a qualitative criterion by which 'the institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security' ('unlikeliness to pay' events); and

b. an objective indicator where 'the obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries', equivalent to the rebuttable presumption in IFRS 9, paragraph B5.5.37.

207.In accordance with Article 178(1) of the CRR, a default event shall be considered to have occurred with regard to a particular obligor when either of the criteria in Article 178(1)(a) and (b) is met, or both are met. In this context, credit institutions shall identify default, in accordance with the 'unlikeliness to pay' criterion of the debtor, before the exposure becomes delinquent with the 90-days-past-due criterion. In line with the approach followed for regulatory purposes, the list of elements provided in Article 178(3) of the CRR as indications of unlikeliness to pay shall be implemented in a way that ensures a timely detection of 'unlikeliness to pay' events that precipitate eventual cash shortfalls.

208. In formulating the estimate of the amount equal to 12-month ECL, credit institutions shall consider reasonable and supportable information, as referred to in the Definitions and in Principle 6 of this Part of the Rule, that affect credit risk, especially forward-looking information, including macroeconomic factors. Credit institutions shall exercise experienced credit judgement to consider both qualitative and quantitative information that may affect the credit institution's assessment of credit risk. IFRS 9 provides that an entity does not need to undertake an exhaustive search for information when measuring an amount equal to 12month ECL. However, credit institutions shall actively incorporate information that may affect the estimate of ECL, and credit institutions shall not exclude or ignore relevant information that is reasonably available.

209. Where a credit institution originates high-credit-risk exposures (which shall not be understood, in the context of this paragraph, as meaning the opposite of 'low credit risk' exposures as described by IFRS 9, paragraph 5.5.10) and their allowances are initially measured at 12-month ECL, the credit institution shall monitor these exposures closely for significant increases in credit risk to ensure a timely movement of the exposure to lifetime ECL measurement, in order to take into account that high risk exposures are likely to exhibit greater volatility and to experience a more rapid increase in credit risk.

210. Even if an increase in credit risk is not judged to be significant, a credit institution shall adjust its estimate of 12-month ECL to appropriately reflect changes in credit risk that have taken place. Such adjustments shall be made well before exposures move, either individually or collectively, to lifetime ECL measurement and taking into account any migration of credit risk which has taken place.

211. Where a collective assessment is performed, exposures within that group shall adhere to the requirements set out in Principle 3 of this Part of the Rule. In particular, where information becomes available to the credit institution indicating that further or different segmentation within a group of lending exposures is required, the group shall be split into subgroups and the measurement of the amount equal to 12-month ECL shall be updated separately for each subgroup or, in the case of transient circumstances, a temporary adjustment shall be applied (see Principle 3 of this Part of the Rule and its detailed requirements on the use of temporary adjustments). Where information becomes available which indicates that a particular subgroup has

suffered a significant increase in credit risk, then lifetime ECL shall be recognised in respect of that subgroup.

212. Lending exposures shall not be grouped in such a way as to obscure the identification of significant increases in credit risk on a timely basis (see also Principles 3 and 4 of this Part of the Rule for additional requirements regarding grouping and collective assessments of ECL).

3.4.2 Assessment of significant increases in credit risk

213. IFRS 9, paragraph 5.5.4, states that 'the objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking.'

214. The rationale for this approach is that the creditworthiness of the counterparty, and thus the ECL anticipated upon initial recognition, is taken into account in the pricing of credit at that time. It follows, then, that a post-origination increase in credit risk may not be fully compensated by the interest rate charged, and, as a consequence, credit institutions shall carefully consider whether there has been a significant increase in credit risk[11]. If so, the lending exposure shall be subject to lifetime ECL measurement.

215. In order to consider whether an exposure has suffered a significant increase in credit risk and the measurement of required 12-month ECL and lifetime ECL, credit institutions shall have in place sound governance, systems and controls, in accordance with the principles specified in this Rule. Unless already established, credit institutions shall implement systems that are capable of handling and systematically assessing the large amounts of information that will be required to judge whether or not particular lending exposures or groups of lending exposures exhibit a significant increase in credit risk, and to measure lifetime ECL where that is the case. Parent undertakings and subsidiaries subject to the CRD shall ensure that the approach is consistent across the group. This shall include, in particular, putting in place processes

[11] IFRS 9 requires entities to consider a wide range of factors in assessing for significant increases in credit risk, and pricing may be one of those factors.

to ensure that forecasts of economic conditions in different jurisdictions and economic sectors are reviewed and approved by a credit institution's senior management, and that the process, controls and economic assumptions around developing forecasts and linking these to expectations of credit loss are consistent across the group. The need for consistency shall not be interpreted as a requirement that the practice be identical across a group. On the contrary, within a consistent framework there may be differences across jurisdictions and products, depending for instance on the availability of data. These differences shall be well documented and justified.

216. Credit institutions' processes in place shall enable them to determine on a timely and holistic basis whether there has been a significant increase in credit risk subsequent to the initial recognition of a lending exposure so that an individual exposure, or a group of exposures with similar credit risk characteristics, is transferred to lifetime ECL measurement as soon as credit risk has increased significantly, in accordance with the IFRS 9 impairment accounting requirements.

217. As noted in paragraph B5.5.17 of IFRS 9 on assessing significant increases in credit risk since initial recognition, the range of information that will need to be considered in making this determination is wide. In broad terms, it will include information on macroeconomic conditions, and the economic sector and geographical region relevant to a particular borrower or a group of borrowers with shared credit risk characteristics, in addition to borrower-specific strategic, operational and other characteristics. A critical feature is the required consideration of all reasonable and supportable forward-looking information that is available without undue cost and effort (see also paragraph 248 of this Rule on the information set to be used), in addition to information about current conditions and historical data.

218. In order to recognise allowances on a timely basis in line with the IFRS 9 requirements, credit institutions shall:

a. assemble data and forward projections for the key drivers of credit risk in their lending exposures and portfolios; and

b. be able to quantify the credit risk in each of their lending exposures or portfolios based on these data and projections.

219. IFRS 9, paragraph B5.5.2, states that lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due and that 'typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example a modification or restructuring) are observed'. Therefore, credit institutions' analyses shall take into account the fact that the determinants of credit losses very often begin to deteriorate a considerable time (months or, in some cases, years) before any objective evidence of delinquency appears in the lending exposures affected. Credit institutions shall be mindful that delinquency data are generally backward-looking, and will seldom on their own be appropriate in the implementation of an ECL approach. For example, within retail portfolios adverse developments in macroeconomic factors and borrower attributes will generally lead to an increase in the level of credit risk long before this manifests itself in lagging information such as delinquency.

220. Thus, in order to meet the objective of IFRS 9 in a robust manner, credit institutions shall also consider the linkages between macroeconomic factors and borrower attributes to the level of credit risk in a portfolio based on reasonable and supportable information. To that end, credit institutions shall start with a detailed analysis of historical patterns and current trends, which would allow for identification of the most relevant credit risk drivers. Experienced credit judgement shall facilitate the incorporation of current and forecasted conditions likely to affect those risk drivers, the expected cash shortfalls and therefore loss expectations.

221. Credit institutions shall perform analyses of this kind not only in the context of portfolios of individually small credits, such as credit card exposures, but also for large, individually managed lending exposures. For example, for a large commercial property loan, credit institutions shall take account of the considerable sensitivity of the commercial property market in many jurisdictions to the general macroeconomic environment, and consider using information such as levels of interest rates or vacancy rates to determine whether there has been a significant increase in credit risk.

222. Credit institutions shall have a clear policy including well-developed criteria on what constitutes a 'significant' increase in credit risk for different types of lending exposures. Such criteria and the reasons why these approaches and definitions are considered appropriate shall be disclosed in accordance with IFRS 7 *Financial*

Instruments: Disclosures, paragraph 35F. IFRS 9, paragraph 5.5.9, requires that, when making the assessment of significant increases in credit risk, 'an entity shall use the change in the risk of default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses'. For these purposes, institutions shall make this assessment in terms of the risk of a default occurring and not expected credit loss (i.e. before consideration of the effects of credit risk mitigants such as collateral or guarantees).

223.In developing their approach to determining a significant increase in credit risk, credit institutions shall consider each of the 16 classes of indicators in IFRS 9 (insofar as they are relevant to the financial instrument being assessed) as set out in paragraphs B5.5.17(a)-(p) and, in addition, credit institutions shall consider whether there is further information that shall be taken into account. Such indicators shall not be viewed as a 'checklist'. Some may be more relevant than others to assessing whether a particular type of lending exposure exhibits a significant increase in credit risk. At the same time, credit institutions shall take particular care to avoid the risk of a significant increase in credit risk not being acknowledged promptly when it is, in fact, present. In particular, credit institutions shall not restrict significant increases in credit risk to situations when a financial instrument is anticipated to become credit impaired (i.e. the third stage of IFRS 9 impairment requirements). Rather, debtors may exhibit a significant increase in credit risk without evidence that the related lending exposures are likely to become impaired. The fact that credit risk has increased significantly does not necessarily mean that default is probable — merely that it is more likely than at initial recognition. This point is underlined by the symmetry of the IFRS 9 model: it is possible for lending exposures to move to lifetime ECL but subsequently be moved back to 12-month ECL if the threshold of a significant increase in credit risk is no longer met.

224. Credit institutions shall consider in particular the following non-exhaustive list of indicators in assessing a significant increase in credit risk:

a. a decision by the credit institution's senior management such that, if an existing lending exposure were newly originated at the reporting date, the element of the price of the lending exposure that reflects the credit risk of the exposure would be significantly higher than it was when the loan was actually originated, because of an increase in the credit risk of the specific borrower or class of borrowers since inception;

b. a decision by the credit institution's senior management to strengthen collateral and/or covenant requirements for new lending exposures that are similar to lending exposures already originated, because of changes in the credit risk of those exposures since initial recognition;

c. a downgrade of a borrower by a recognised credit rating agency, or within a credit institution's internal credit rating system;

d. for performing lending exposures subject to individual monitoring and review, an internal credit assessment summary/credit-quality indicator that is weaker than upon initial recognition;

e. deterioration of relevant determinants of credit risk (e.g. future cash flows) for an individual obligor (or pool of obligors); and

f. expectation of modification due to financial difficulties, including those qualifying as forbearance in accordance with Regulation (EU) 2015/227.

While implementation of IFRS 9 shall reflect credit risk management practices where possible, in some cases that would not be appropriate. If, for example, a credit institution manages most lending exposures in the same way regardless of credit risk — with the exception only of particularly strong or weak credits — the manner in which a lending exposure is managed is unlikely to be a sound indicator of whether there has been a significant increase in credit risk.

225.When assessing whether there has been a significant increase in credit risk for a lending exposure, credit institutions shall also take into account the following factors which are related to the environment in which a credit institution or the borrower operates:

a. deterioration of the macroeconomic outlook relevant to a particular borrower or to a group of borrowers. Macroeconomic assessments shall be sufficiently rich to include factors relevant to sovereign, corporate, household and other types of borrower. Furthermore, they shall address any relevant regional differences in economic performance within a jurisdiction[12;] and

[12] See Principle 6 of this Part of the Rule on the consideration of forward-looking information, including macroeconomic factors.

b. deterioration of prospects for the sector or industries within which a borrower operates.

226.Accurate identification of drivers of credit risk, and reliable demonstration of the linkages between those drivers and the level of credit risk, shall be considered as critical, as a seemingly small change in a qualitative characteristic of a loan can potentially be a leading indicator of a large increase in the risk of a default occurring. Furthermore, in accordance with IFRS 9, paragraph 5.5.9, the significance of a change in credit risk since initial recognition depends on the risk of a default occurring at initial recognition. In this regard, where a credit institution uses changes in PD as a means of identifying changes in the risk of a default occurring, it shall take into consideration the significance of a given change in PD expressed in a ratio (or the rate of fluctuation) proportionate to the PD at initial recognition (i.e. a change in the PD divided by the PD at initial recognition), considering also paragraph B5.5.11of IFRS9. However, the width of the change in PD itself (i.e. PD at measurement date minus PD at initial recognition) shall also be taken into consideration

227.Credit institutions shall look beyond how many 'grades' a rating downgrade entails because the change in PD for a one-grade movement may not be linear (for example, the default probability over five years of an exposure rated BB is around three times that of one rated BBB, based on current data and analyses applicable to certain jurisdictions). Furthermore, because the significance of a one-grade movement would depend on the granularity of a bank's rating system — and hence the 'width' of each grade — an appropriate initial segmentation shall be defined to ensure that a significant increase in credit risk for an individual lending exposure or a group of lending exposures is not obscured within a segment. In this regard, credit institutions shall ensure that credit risk rating systems include a sufficient number of grades to appropriately distinguish credit risk. Credit institutions shall also be mindful of the fact that a significant increase in credit risk could occur prior to a movement in a credit grade.

228.Credit institutions shall take into account that there are some circumstances in which an adverse movement in the factors listed in paragraphs 224 and 225 above might not be indicative of a significant increase in credit risk. For example, it may be the case that the default probability of a lending exposure rated AA is low, and not much greater than one rated AAA. However, very few lending exposures are of such

apparently low credit risk — and, as noted in paragraph 227, the sensitivity of default probability to rating grades may increase strongly as rating quality declines.

229. Credit institutions shall also be aware that there could be circumstances in which some factors move in an adverse direction but may be counterbalanced by improvement in others (see IFRS 9 Implementation Guidance, Example 2). Nonetheless, in view of the importance of detecting whether there has been a significant increase in credit risk, credit institutions shall put in place governance and control processes capable of reliably validating any judgement that factors which may have an adverse impact on credit risk are counterbalanced by factors which may have a favourable impact.

230. Credit institutions shall give thorough consideration and full weight to discretionary decisions by a credit institution's board of directors or senior management which point to a change in credit risk. For example, if because of concerns about credit risk a decision is made to intensify the monitoring of a borrower or class of borrowers, it is unlikely that such action would have been taken by the decision-maker had the increase in credit risk not been perceived as significant.

231. When a credit institution assesses that there has been a significant increase in credit risk for some, but not all, of its lending exposures to a counterparty — for example, because of differences in the timing of when lending was provided — it shall ensure that all lending exposures are identified where there has been a significant increase in credit risk.

232. Where a credit institution makes the assessment of significant increases in credit risk on a collective basis (i.e. such as retail), the definitions of portfolios shall be reviewed regularly to ensure that the lending exposures within them continue to share risk characteristics in terms of their response to credit risk drivers. Changing economic conditions may require regrouping.

233. In line with paragraph B5.5.1 of IFRS 9 on the assessment of significant increases in credit risk since initial recognition on a collective basis, in instances where it is apparent that, within a group of lending exposures, some lending exposures have experienced a significant increase in credit risk, credit institutions shall transfer a subset or a proportion of the group of lending exposures to lifetime ECL

measurement even though it is not possible to identify this on an individual lending exposure basis (see IFRS 9, Illustrative Example 5).

234. Consistent with paragraph B5.5.6 of IFRS 9 and paragraph IE39 of the Implementation Guidance for IFRS 9, if it is not possible on the basis of shared credit risk characteristics to identify a particular subgroup of lending exposures for which credit risk has increased significantly, an appropriate proportion of the overall group shall be subject to lifetime ECL measurement.

235. 'Significant' shall not be equated with statistical significance, meaning that the assessment approach shall not be based solely on quantitative analysis. For portfolios which have a large number of individually small credits, and a rich set of relevant historical data, it may be possible to identify 'significant' increases in credit risk in part by using statistical techniques. However, for other lending exposures, that may not be feasible.

236. 'Significant' shall also not be judged in terms of the extent of impact on a credit institution's primary financial statements. Identification and disclosure of significant increases in credit risk shall be undertaken, even where an increase in credit risk defined in terms of probability of default is unlikely to affect the allowance made — for example, because the exposure is more than fully collateralised — to allow credit institutions to identify and disclose such increases which are likely to be important to users seeking to understand trends in the intrinsic credit risk of a credit institution's lending exposures.

237. In accordance with IFRS 9, paragraph 5.5.9, the assessment of significant increases in credit risk is based on comparing credit risk on exposures at the reporting date relative to credit risk upon initial recognition. IFRS 9, paragraph BC 5.161, and Illustrative Example 6 represent an example of the application of this principle in the Standard, rather than an exception to that principle. This example suggests that credit institutions can set a maximum credit risk for particular portfolios upon initial recognition that would lead to that portfolio moving to lifetime ECL measurement when credit risk increases beyond that maximum level. This simplification is only relevant when exposures are segmented on a sufficiently granular basis such that a credit institution can demonstrate that the analysis is consistent with the principles of IFRS 9. Specifically, credit institutions shall be able to demonstrate that a significant

increase in credit risk had not occurred for items in the portfolio before the maximum credit grade was reached.

238. Credit institutions shall rigorously review the quality of their approach to assessing whether credit risk has increased significantly. A credit institution's board of directors or senior management shall consider whether there are additional factors that shall be taken into account in the assessment of significant increases in credit risk which would improve the quality of their approach.

239. Credit institutions shall be alert to any possibility of bias being introduced that would prevent the objectives of IFRS 9 from being met. In cases where credit institutions believe that their approach to implementation is likely to have introduced bias, they shall change their assessment for identified bias and thus ensure that the objective of the Standard is met (see in particular IFRS 9, paragraphs B5.5.1-B5.5.6).

240. IFRS 9, in paragraphs 5.5.12 and B5.5.25-B5.5.27, sets out the requirements for the assessment of significant increases in credit risk for lending exposures whose contractual cash flows have been renegotiated or modified. In particular, for modifications that do not result in derecognition in accordance with IFRS 9, an entity must assess whether credit risk has increased significantly by comparing (a) the risk of a default occurring at the reporting date based on the modified contractual terms with (b) the risk of default occurring upon initial recognition based on the original, unmodified contractual terms.

241. Credit institutions shall ensure that modifications or renegotiations do not obscure increases in credit risk and thereby cause ECL to be underestimated and to delay the transfer to lifetime ECL for obligors whose credit risk has significantly deteriorated, or inappropriately result in a move from lifetime ECL measurement back to 12-month ECL measurement.

242. When determining whether there is a significant increase in credit risk for a modified lending exposure, credit institutions shall be able to demonstrate, and shall take into account when developing ECL estimates, whether such modifications or renegotiations have improved or restored the ability of the credit institution to collect interest and principal payments compared with the situation upon initial recognition. Consideration shall also be given to the substance of modified contractual cash flows

as well as the implications of the modifications for the future credit risk of the lending exposure (taking into consideration the obligor's credit risk). Factors to consider include, but are not limited to, the following:

a. whether the modification or renegotiation of the contractual terms and resulting cash flows is economically beneficial to the obligor, compared with the original, unmodified contractual terms, and how the modification economically affects the obligor's ability to repay the debt;

b. whether factors can be identified that support a credit institution's assessment of the obligor's ability to repay the debt, including circumstances leading up to the modification, and future prospects of the obligor as a result of the modifications, considering current conditions, macroeconomic forecasts, and prospects for the sector/industry within which the obligor operates, the obligor's business model, and the obligor's business (management) plan that outlines the obligor's expectations of its future performance, financial resilience and cash flows; and

c. whether the obligor's business plan is feasible, realisable and consistent with the repayment schedule of interest and principal under the modified contractual terms of the lending exposure.

243. Lending exposures transferred to lifetime ECL that are subsequently renegotiated or modified, and not derecognised, shall not move back to 12-month ECL measurement unless there is sufficient evidence that the credit risk over the life of the exposure has not increased significantly compared with that upon initial recognition. For example, where a credit institution grants various concessions such as interest rate reductions or postponements of principal repayments to obligors in financial difficulty, the lending exposure may exhibit characteristics of a lower credit risk even though in reality the obligor may continue to experience financial difficulty with no realistic prospects of making scheduled repayments over the remaining term of the exposure. In accordance with paragraph B5.5.27 of IFRS 9 'evidence that the criteria for the recognition of lifetime ECL are no longer met could include a history of up-to-date and timely payment performance against the modified contractual terms. Typically, a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed or incomplete payments would not

typically be erased by simply making one payment on time following a modification of the contractual terms'.

3.4.3 Use of practical expedients

244. IFRS 9 includes a number of practical expedients, intended to ease the implementation burden for a wide range of companies in recognition of the fact that IFRS 9 will be used by a variety of entities, including entities outside the banking industry.

245. The paragraphs below address the following practical expedients: the information set which an entity must consider in measuring ECL; the exception for 'low' credit risk exposures; and the 30-days-past-due rebuttable presumption.

246. Credit institutions shall make limited use of those practical expedients as they have the potential to introduce significant bias and because — given their business — the cost of obtaining the relevant information is not likely to involve 'undue cost or effort'. Credit institutions shall consider the need to make adjustments when using practical expedients to avoid any resulting bias, as they shall take into account that the objective of IFRS 9 is to estimate expected credit losses to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes (IFRS 9, paragraph 5.5.17).

247. Where a credit institution uses such practical expedients, justifications for the use of practical expedients shall be clearly documented by the credit institution.

3.4.4 The information set

248. IFRS9, paragraph B5.5.15, states that ´an entity shall consider reasonable and supportable information that is available without undue cost and effort´ and that 'an entity need not undertake an exhaustive search for information when determining whether credit risk has increased significantly since initial recognition'. Credit institutions shall not read these statements restrictively and shall develop systems and processes that use all reasonable and supportable information that is relevant to the group of exposures or individual exposure, as needed to achieve a high-quality, robust and consistent implementation of the accounting requirements. Nevertheless,

additional cost and operational burden do not need to be introduced where they do not contribute to a high-quality implementation of IFRS 9.

3.4.5 'Low credit risk' exemption

249. In accordance with paragraph 5.5.10 of IFRS 9, ´an entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have a low credit risk at the reporting date´. Although credit institutions thus have the option for 'low credit risk' exposures not to assess whether credit risk has increased significantly since initial recognition, use of this exemption shall be limited. In particular, credit institutions shall conduct timely assessment of significant increases in credit risk for all lending exposures.

250. In that context, credit institutions shall always recognise changes in 12-month ECL through the allowance where there is not a significant increase in credit risk and move lending exposures to lifetime ECL measurement, if there is a significant increase in credit risk. In order to achieve a high-quality implementation of IFRS 9, any use of the low-credit-risk exemption shall be accompanied by clear evidence that credit risk as of the reporting date is sufficiently low that a significant increase in credit risk since initial recognition could not have occurred.

251. To illustrate the meaning of low credit risk in IFRS 9, paragraph B5.5.22, IFRS 9, paragraph B5.5.23, cites as an example an instrument with an external 'investment grade' rating. However, all lending exposures that have an 'investment grade' rating from a credit rating agency cannot automatically be considered low credit risk. Credit institutions shall rely primarily on their own credit risk assessments in order to evaluate the credit risk of a lending exposure, and not rely solely or mechanistically on ratings provided by credit rating agencies (where the latter are available). Nevertheless, optimistic internal credit ratings, as compared with external ratings, shall require additional analysis and justification by a credit institution's board of directors or senior management.

3.4.6 More-than-30-days-past-due rebuttable presumption

252. Credit institutions shall have credit risk assessment and management processes in place to ensure that significant credit risk increases are detected well ahead of

exposures becoming past due or delinquent. Although the use of the more-than-30-days-past-due rebuttable presumption as a backstop measure is not precluded in accordance with IFRS 9 alongside other, earlier indicators for assessing significant increase in credit risk, credit institutions shall avoid using it as a primary indicator of transfer to lifetime ECL.

253. Any assertion that the more-than-30-days-past-due presumption is rebutted on the basis that there has not been a significant increase in credit risk shall be accompanied by a thorough analysis clearly demonstrating that 30 days past due is not correlated with a significant increase in credit risk. Such analysis shall consider both current and reasonable and supportable forward-looking information that may cause future cash shortfalls to differ from historical experience.

254. In this regard, credit institutions shall use relevant forward-looking information that is reasonable and supportable to analyse whether there is any substantive relationship between such information and credit risk drivers. Credit institutions shall not use the 30-days-past due rebuttable presumption unless they have demonstrated that the forward-looking information had no substantive relationship with the credit risk driver or such information is not available without undue cost or effort.

255. In the limited instances where past-due information is the best criterion available to a credit institution to determine when exposures shall move to the lifetime ECL category, credit institutions shall pay particular attention to their measurement of 12-month ECL allowance to ensure that ECL are appropriately captured in accordance with the measurement objective of IFRS 9. Moreover, credit institutions shall take into account that significant reliance on backward-looking information will introduce bias into the implementation of an ECL accounting model and that they shall ensure that the objectives of the IFRS 9 impairment requirements (i.e. to reflect ECL that meet the stated measurement objectives and to capture all significant increases in credit risk) are met.

PART 4 – MANAGEMENT OF NON-PERFORMING AND FORBORNE EXPOSURES

4.1 NPE Strategy

256. This Part of the Rule sets out the key elements for developing and implementing an NPE strategy. Credit institutions shall have in place an adequate framework to identify, measure, manage, monitor and mitigate NPEs, including through workout activities.

257. In the development and implementation of their NPE strategies, credit institutions shall take into account relevant consumer protection considerations and requirements, and ensure fair treatment of consumers.

4.1.1 Developing the NPE strategy

258. Credit institutions shall establish an NPE strategy to target a time-bound reduction of NPEs over a realistic but sufficiently ambitious time horizon (NPE reduction targets). The credit institution shall ensure that the NPE strategy lays out its approach and objectives regarding effective management to maximise recoveries and ultimately a reduction in NPE stocks in a clear, credible and feasible manner for each relevant portfolio. When developing and implementing the NPE strategy for retail portfolios, the credit institution shall consider provisions aimed at protecting consumers, including Directive 2014/17/EU[13] ('the MCD'), Directive 2008/48/EC[14] ('the CCD') and the Fourth Schedule of the Credit Agreements for Consumers Relating to Residential Immovable Property (S.L. 378. 10)

259. Credit institutions shall have regard to the following steps which shall form the core building blocks of the development and implementation of the NPE strategy:
    a. assessment of the operating environment and external conditions (see Section 4.1.2);

    b. development of the NPE strategy over short-, medium- and long-term time horizons (see Section 4.1.3);

[13] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010
[14] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC

c. implementation of the operational plan (see Section 4.1.4);

d. fully embedding the NPE strategy into the management processes of the credit institution, including regular review and independent monitoring (see Section 4.1.5).

260. When credit institutions develop their NPE strategy, they shall also consider policies that aim to ensure the fair treatment of borrowers.

4.1.2 Assessing the operating environment

261. As a first phase in the formulation and execution of an appropriate NPE strategy, credit institutions shall complete an assessment of the following elements:

a. internal capabilities to effectively manage and reduce NPEs;

b. external conditions and operating environment;

c. the capital implications of the NPE strategy.

4.1.2.1 Internal capabilities/self-assessment

262. Credit institutions shall perform a comprehensive self-assessment to evaluate the actual situation and the steps to be taken internally to address any gaps in the internal capabilities to manage NPEs.

263. Credit institutions shall fully understand and assess:

a. The magnitude and drivers of their NPEs:

i. the size and evolution of NPE portfolios at an appropriate level of granularity, which requires an appropriate grouping of the exposures, as outlined in Section 4.2.2.3;

ii. the drivers of NPE inflows and outflows, by portfolio where relevant;

iii. other potential correlations and causations.

b. The outcomes of NPE actions taken by the credit institution in the past:

i. the types and nature of actions implemented, including forbearance activities;

ii. the effectiveness of those activities and related drivers.

c. Their operational capacities (processes, tools, data quality, IT/automation, staff/expertise, decision-making, internal policies and any other relevant area for the implementation of the strategy) in relation to the various steps involved in the process, including but not limited to:

i. early identification of NPEs;

ii. forbearance activities;

iii. impairments and write-offs

iv. collateral valuations;

v. recovery, legal process and foreclosure;

vi. management of foreclosed assets, where relevant;

vii. reporting and monitoring of NPEs and of the effectiveness of NPE workout solutions.

264. Credit institutions shall perform a comprehensive self-assessment covering at least the items listed in paragraph 263 on an annual basis to determine strengths, significant gaps and areas of improvement required to reach NPE reduction targets.

265. Credit institutions shall report the outcome of the comprehensive self-assessment to the credit institution's board of directors and the Authority.

266. Credit institutions shall consider seeking expert views on their operational capabilities to manage NPEs from the credit institution's risk management and control functions or from external sources on a periodic basis.

4.1.2.2 External conditions and operating environment

267. Credit institutions shall assess and consider the current and likely future external operating conditions and environment when establishing the NPE strategy and associated NPE reduction targets. The following list of external factors, where appropriate, should be taken into account by credit institutions when setting the NPE strategy:

   a. The macroeconomic conditions, including the dynamics of the real estate market or other relevant sectors, taking into account sector concentrations in NPE portfolios.

   b. Market expectations with regard to acceptable NPE levels and coverage, including but not limited to the views of rating agencies and market analysts, and available research, taking proper account also of the interests of borrowers.

   c. NPE investor demand, including trends in and the dynamics of the domestic and international NPE markets for portfolio sales.

   d. The maturity of the NPE servicing industry and the availability and coverage of specialised servicers.

   e. The regulatory, legal and judicial framework. Credit institutions shall have a good understanding of the legal proceedings related to NPE workout for different types of assets and different jurisdictions depending on NPE's location. In particular, credit institutions shall assess the average duration of such proceedings, the average financial outcomes, the rankings of different types of exposures and related implications for outcomes, the influence of the types and rankings of collateral and guarantees on the outcomes, the impact of consumer protection issues on legal decisions, and the average total costs associated with legal proceedings. Legal provisions aimed at protecting consumers, in particular for residential mortgage exposures, should also be considered by credit institutions when setting the NPE strategy.

   f. The national tax implications of impairments and NPE write-offs.

4.1.2.3 Capital implications of the NPE strategy

268. Credit institutions shall be able to calculate a detailed assessment of the impact of the planned strategy from capital, risk exposure amount, profit or loss, and impairment perspectives for each of the reduction drivers, and they should assess whether the bank has identified a strategic process to resolve any shortfalls under different economic scenarios. The assessment criteria, underlying assumptions and implications should be aligned with the RAF as well as with the ICAAP.

269. Credit institutions should include suitable actions in their capital planning to ensure that the level of available capital will enable a sustainable reduction of NPEs on the balance sheet.

4.1.3 Development of the NPE strategy

270. The credit institution shall ensure that the NPE strategy encompasses, at a minimum, time-bound quantitative NPE targets and foreclosed assets targets, supported, where appropriate, by a corresponding comprehensive operational plan. When developing the NPE strategy, the credit institution shall take into consideration a self-assessment process and an analysis of the strategic options which are undertaken for the implementation of the NPE strategy. Credit institutions shall ensure that the NPE strategy and the operational plan are defined and approved by the board of directors and reviewed at least annually.

4.1.3.1 Strategy implementation options

271. Credit institutions shall consider including a combination of strategies and options in the NPE strategy to achieve their objectives over the short, medium and long term. In order to successfully operationalise the NPE strategy, credit institutions shall consider at least the following non-mutually exclusive implementation options for different portfolios and under different conditions:
    a. Hold/forbearance strategy: suitable workout strategy and forbearance options. The hold strategy option is strongly linked to the credit institution's operating model, forbearance and borrower assessment expertise, operational NPE management capabilities, outsourcing of servicing and write-off policies.

    b. Active portfolio reductions: sales, securitisation or, in the case of NPEs that are deemed unrecoverable, write-offs. This option is strongly linked to adequacy of

impairments, collateral valuations, quality of exposure data and investors' demand for NPEs.

c. Change of type of exposure or collateral, including foreclosure, debt to equity swapping, debt to asset swapping or collateral substitution.

d. Legal options: including insolvency proceedings or out-of-court solutions.

272. Credit institutions shall identify medium- and long-term strategy options for NPE reductions that may not be achievable immediately, for example due to a lack of immediate NPE investor demand, which might change in the medium to long term. The operational plan may therefore need to allow for such changes and require preparations for them, for example by enhancing the quality of NPE data in order to be ready for future investor transactions.

273. When a credit institution concludes that none of the above options will lead to a sufficient NPE reduction in the medium to long term for certain portfolios or individual exposures, the credit institution shall clearly reflect this in a timely impairment and write-off approach.

274. Credit institutions aiming to engage in complex processes, such as NPE risk transfer and securitisation transactions, shall conduct robust risk analysis and have adequate risk control processes in place.

4.1.3.2 Targets

275. Before commencing the short- to medium-term target-setting process, credit institutions shall establish a view of reasonable long-term NPE levels, both at portfolio level and at aggregate level. Credit institutions shall take into account historic or international benchmarks in order to define reasonable long-term NPE levels.

276. Credit institutions shall include, at a minimum, clearly defined realistic yet ambitious quantitative targets in their NPE strategy, including for foreclosed assets, where relevant. These targets should lead to a concrete reduction, gross and net of impairments, in NPEs, at least in the medium term. While expectations about changes in macroeconomic conditions, when based on solid external forecasts, can play a role in determining target levels, they should not be the sole driver of the NPE reduction targets established.

277. Credit institutions shall establish targets as following:
   a. by time horizons (short-term (indicative one year), medium-term (indicative three years) and possibly long-term);

   b. by main portfolios (e.g. retail mortgage, retail consumer, retail, small and medium-sized enterprises (SMEs), corporate, large corporate, commercial real estate);

   c. by implementation options (e.g. cash recoveries from a hold strategy, collateral repossessions, recoveries from legal proceedings, revenues from sales of NPEs or writeoffs).

278. Credit institutions shall ensure that the NPE targets include, at a minimum, a projected absolute or relative NPE reduction, both gross and net of impairments, not only on an overall basis but also for the main NPE portfolios. Where foreclosed assets are material, the credit institutions shall define a foreclosed assets strategy or, at least, credit institutions shall include foreclosed assets reduction targets in the NPE strategy.

279. Credit institutions shall align the NPE targets with the more granular operational targets. Credit institutions can implement further monitoring indicators as additional targets, if deemed appropriate.

4.1.3.3 Operational plan

280. Credit institutions shall ensure that their NPE strategy is supported by an operational plan, which shall be defined, approved and reviewed by the board of directors. Credit institutions shall ensure that the operational plan clearly defines how the credit institution will operationally implement its NPE strategy over a time horizon of at least one to three years (depending on the type of operational measures required).

281. The credit institution shall include in its NPE operational plan at least the following:
   a. clear time-bound objectives and goals;

   b. activities to be carried out on a portfolio basis;

   c. governance arrangements and structures, including responsibilities and reporting mechanisms for activities and outcomes;

d. quality standards to ensure successful outcomes;

e. staffing and resource requirements;

f. required technical infrastructure and an enhancement plan;

g. granular and consolidated budget requirements for the implementation of the NPE strategy;

h. plans for communication with internal and external stakeholders.

282. The operational plan shall have a specific focus on internal factors that could present impediments to the successful delivery of the NPE strategy.

4.1.4 Implementing the operational plan

283. The implementation of the NPE strategy operational plan shall rely on suitable policies and procedures, clear ownership and appropriate governance structures, including escalation procedures, and the operational plan should incorporate wide-ranging change management measures in order to embed the NPE workout framework as a key element in the corporate culture.

284. Within a month following each year-end of the NPL Strategy, the credit institution shall conduct a yearly self-assessment of its performance against the set milestones within the NPL Strategy and submit such self-assessment to the competent authority.

285. Credit institutions shall report any material deviations from the operational plan to the board of directors and to the Authority in a timely manner, together with appropriate remediation actions to be put in place.

4.1.5 Embedding the NPE strategy

286. As the execution and delivery of the NPE strategy will involve and depend on many different areas within the credit institution, the NPE strategy shall be embedded in processes at all levels of the credit institutions, including strategic and operational, including the risk committee as defined in Banking Rule 24, section 5.4.

287. Credit institutions shall emphasise to all relevant staff the key components of the NPE strategy in line with the approach taken to the credit institution's overall strategy and

in particular the risk strategy. This is especially important if the implementation of the NPE strategy will involve wide-ranging changes to business procedures.

288. Credit institutions shall clearly define and document the roles, responsibilities and formal reporting lines for the implementation of the NPE strategy and operational plan.

289. Staff and management involved in NPE workout activities shall be provided with clear individual (or team) goals and incentives geared towards reaching the targets agreed in the NPE strategy and operational plan. Related remuneration policies, career development objectives and performance monitoring frameworks shall take into account the NPE targets in order to ensure the full engagement of staff and management with NPE reduction and shall also have regard to the fair treatment of consumers. The incentive scheme for staff and managers in the loan origination/business units shall also take into account the feedback from the workout activities and the quality of the credit institution's exposures in order to disincentivise excessive risk taking. With regard to retail exposures, these remuneration policies shall be developed in accordance with the provisions laid down in BR/21 on Remuneration Policies and Practices.

290. Credit institutions shall ensure that all relevant components of the NPE strategy are fully aligned with and integrated into the business plan and budget, including all the relevant costs associated with the implementation of the operational plan, and also potential losses stemming from NPE workout activities.

291. Credit institutions shall fully embed the NPE strategy in their risk management framework. In this context, credit institutions shall give special attention to:

   a. ICAAP:[15] all relevant components of the NPE strategy shall be fully aligned with and integrated into the ICAAP. Credit institutions shall prepare quantitative and qualitative assessments of NPE developments under base and stressed conditions including the impact on capital planning.

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[15] As defined in Article 108 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

b. RAF:[16] RAF and NPE strategies shall be closely interlinked. In this regard, credit institutions shall have clearly defined RAF metrics and limits which are approved by the board of directors, and ensure that these are aligned with the core elements and targets which form part of the NPE strategy.

c. Recovery plan:[17] where NPE-related indicator levels and actions form part of the recovery plan, credit institutions shall ensure that these are aligned with the NPE strategy targets and operational plan.

292. Credit institutions shall ensure that there is a high level of monitoring and oversight by the risk management functions in respect of the formulation and implementation of the NPE strategy and operational plan.

4.2 NPE governance and operations

293. In order to be able to address the NPE issues in an efficient and sustainable manner, credit institutions shall have in place an appropriate governance structure and operational set-up.

294. This section sets out the key elements of governance and operations in relation to an NPE workout framework, covering aspects related to steering and decision-making, the NPE operating model, the internal control framework and NPE monitoring processes.

295. When implementing the NPE governance and operations, credit institutions shall take into account relevant consumer protection considerations and requirements, and ensure fair treatment of consumers.

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[16] As described in the Financial Stability Board's 'Principles for an effective risk appetite framework'.

[17] As required by Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

4.2.1 Steering and decision-making

296. The credit institution's overarching strategy and its implementation shall cover the NPE strategy and operational plan, which should therefore be set, approved and reviewed by the board of directors. In particular, the board of directors shall:
    a. approve annually and regularly review the NPE strategy and operational plan in line with the overall risk strategy;

    b. oversee the implementation of the NPE strategy;

    c. define quantitative and qualitative management objectives and incentives for NPE workout activities;

    d. monitor on a quarterly basis progress made in comparison with the targets defined in the NPE strategy and operational plan;

    e. define adequate approval processes for NPE workout decisions (for large NPEs, these shall require the approval of the board of directors);

    f. approve NPE-related policies (including those listed in Annex 4) and processes, review them at least annually and proceed with any necessary amendments, and ensure that the policies and processes are completely understood by the staff;

    g. ensure sufficient internal controls on NPE management processes, with a special focus on activities linked to NPE classifications, impairments, write-offs, collateral valuations and the sustainability of forbearance solutions;

    h. have sufficient knowledge, experience and expertise with regard to the management of NPEs.

297. The board of directors and senior management shall dedicate an amount of their capacity and devote sufficient time to NPE workout-related matters in line with Section 5.4 of Banking Rule 24, in proportion to the risks connected to NPEs within the credit institution. Credit institutions shall establish and document clearly defined, efficient and consistent decision-making procedures, with adequate second line of defence involvement at all times.

4.2.2 NPE operating model

4.2.2.1 NPE workout units

298. In order to mitigate sufficiently any conflict of interest in managing NPEs, as well as to make good use of dedicated NPE expertise across the organisation, credit institutions shall establish dedicated NPE workout units (NPE WUs) that are independent from the loan origination activities. This separation of duties approach should encompass not only client relationship activities but also the decision-making process. In this context, credit institutions shall consider implementing dedicated decision-making bodies related to NPE workout such as an NPE committee.

299. Where overlaps with the decision-making bodies, managers or experts involved in the loan origination process are unavoidable, the framework of the credit institution and its internal controls shall provide that any potential conflicts of interest are sufficiently mitigated.

300. Credit institutions shall have in place arrangements which ensure that regular feedback between loan origination units and NPE WUs is established.

301. When designing an appropriate NPE WU structure, credit institutions shall take into account the specificities of their main NPE portfolios, including the type of exposure (such as retail, SME, corporate) and the type of collateral.

302. Credit institutions shall consider designing automated processes for NPE WUs for homogeneous retail NPE portfolios. For corporate NPE portfolios, where relevant, and depending on the sectoral concentration of the NPEs, credit institutions shall consider a relationship management approach with sectoral specialisation of NPE WU staff. For sole traders and micro-enterprises, a combination of automated elements and a relationship management approach shall be considered.

303. Small and less complex credit institutions (as defined in Article 4(1)(145) of the CRR) may have in place dedicated workout functions proportionate to their size, nature, complexity and risk profile. Credit institutions shall ensure that the design of such functions prevents and eliminates conflict of interest in the management of NPEs.

304. As an alternative to establishing dedicated decision-making bodies related to NPE workout, for proportionality purposes, small and less complex credit institutions may

cover the necessary requirements through their existing credit or risk committees, as long as it is ensured that conflicts of interest are sufficiently mitigated.

4.2.2.2 Alignment with the NPE life cycle

305. Credit institutions shall set up NPE WUs to ensure that NPE workout activities and borrower engagements are tailored to the phases of the NPE life cycle.[18] Credit institutions shall set up different NPE WUs for the different phases of the NPE life cycle and also for different portfolios, as appropriate. All applicable workout stages shall receive adequate focus and shall be equipped with sufficiently specialised staff.

306. Credit institutions shall consider the following phases in the NPE life cycle, taking into account also the specificities of the products and the nature of the arrears:

   a. Early arrears (up to 90 days past due):[19] during this phase, the credit institution shall focus on the initial engagement with the borrower for early recoveries and on collecting information to enable a detailed assessment of the borrower's circumstances. The type of exposure and collateral shall ultimately determine the most suitable workout strategy, which may involve forbearance measures with a short-term time horizon, to be applied when necessary (including during this initial period, where appropriate), with the aim of stabilising the financial position of the borrower before establishing a suitable workout strategy. In addition, the credit institution shall, where appropriate, seek options to improve its position while taking into account the rights and interests of consumers (such as by signing new loan documents, perfecting outstanding collateral, minimising cash leakage, taking additional collateral if available). A dedicated arrears management policy shall be in place and shall contain guidance on the overall NPE workout procedures and responsibilities, including handover triggers.

   b. Late arrears/forbearance: credit institutions shall implement and formalise forbearance arrangements with borrowers. Credit institutions shall put in place forbearance arrangements only where it is satisfied that the borrower can afford to make the repayments. In considering whether a restructuring option is viable,

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[18] This also encompasses assets not classified as NPEs – such as early arrears, FBEs and foreclosed assets – that play an essential role in the NPE workout process.

[19] Unlikely to pay exposures could be part of either early arrears or NPE WUs, depending on their complexity.

credit institutions shall have regard to regulation 17C of the Credit Agreements for Consumers Relating to Residential Property Regulations (S.L. 378. 10) and other legal provisions aimed at protecting consumers, to the extent applicable. A forbearance arrangement shall be monitored for at least one year in line with Commission Implementing Regulation (EU) No 451/2021, given the increased risk, before it can eventually be transferred out of the NPE WUs if no further NPE triggers are observed.

c. Liquidation/debt recovery/legal cases/foreclosure: if no viable forbearance solution has been found due to the borrower's financial circumstances or cooperation level, credit institutions shall perform a cost–benefit analysis of different liquidation options, including in-court and out-of-court procedures, having regard also to the interests of the borrower. Based on this analysis, credit institutions shall speedily proceed with the chosen liquidation option, supported by legal and business liquidation expertise. In cases where credit institutions are engaged in extensive use of external experts, they shall ensure that sufficient internal control mechanisms are in place to ensure an effective and efficient liquidation process. NPEs that have been categorised as such for a long period of time should be given special attention in this regard. A dedicated debt recovery policy shall be in place and shall contain guidance on the liquidation procedures.

307. Managing foreclosed assets (or other assets stemming from NPEs): collateral repossession generally commences after other attempts by the credit institution to collect the outstanding amounts have failed. The credit institution shall have a policy in place that describes the recovery process for foreclosed assets, covering in particular the steps of repossession, valuation of the collateral and realisation of various types of collateral through appropriate means.

4.2.2.3 Grouping exposures

308. Part 3 of this Rule describes the policies for credit institutions of grouping exposures with shared credit risk characteristics. Homogeneous portfolios should be built up in order to tailor treatments specifically to NPEs. Credit institutions shall consider designing customised processes for each portfolio, with a dedicated expert team taking ownership of each. NPE portfolios shall be analysed with a high degree of granularity, resulting in clearly defined borrower sub-portfolios. For these analyses,

credit institutions shall develop appropriate management information systems and sufficiently high data quality.

309. A list of potential selection criteria for grouping retail NPEs into portfolios is contained in Annex 1.

310. For corporate NPE portfolios, grouping by asset class or sector shall be considered a key driver for NPE WU specialisation. Credit institutions shall then further divide these portfolios in line with the NPE strategy and the level of financial difficulty to ensure that workout activities are sufficiently focused.

4.2.2.4 Human resources

311. Credit institutions shall have in place an appropriate organisational framework relative to their business model and taking into account their risks, including risks stemming from NPEs. Credit institutions shall devote an appropriate and proportionate amount of management attention and resources to the workout of NPEs and to internal controls on related processes.

312. Sharing management and resources with other parts of the value chain shall be carefully reviewed before implementation in order to avoid conflicts of interest and to ensure sufficient specialisation, as discussed above.

313. Based on the findings of the credit institution's NPE self-assessment on capabilities, as referred to in section 4.1.2.1, credit institutions shall regularly review the adequacy of their internal and external NPE workout resources and address any human resourcing gaps in a timely fashion. As workout activities may place significant demands on resources, credit institutions shall consider if it is appropriate to use fixed-term contracts, internal/external outsourcing or joint ventures for NPE workout activities. However, the final responsibility for these activities remains with the credit institution. In the event that outsourcing is used, credit institutions shall ensure that such outsourcing is arranged in accordance with Banking Rule 14 on Outsourcing and any other applicable legislation or regulatory requirements.

314. Credit institutions shall build up the relevant expertise required for the defined NPE operating model, including the NPE WUs and internal control functions, in line with the provisions of the joint ESMA and EBA Guidelines on the assessment of the

suitability of members of the management body and key function holders (EBA/GL/2021/06). Credit institutions shall ensure that staff allocated to key NPE workout tasks should have specific NPE expertise and experience. Credit institutions shall implement adequate and dedicated NPE training, including on consumer protection, and shall design staff development plans to build in-house expertise using available talent.

315. Where it is not possible or efficient to build in-house expertise and infrastructure, credit institutions shall ensure that NPE WUs have easy access to qualified independent external resources or to dedicated NPE servicing companies.

316. In line with the overall NPE strategy and operational plan, credit institutions shall implement an appraisal system tailored to the requirements of the NPE WUs. The appraisal system shall be designed in line with the provisions of the BR/21 on Remuneration Policies and Practices in particular Part II and Part III for retail exposures of such Rule, and Article 5 of the Credit Agreements for Consumers Relating to Residential Property Regulations (S.L. 378. 10). The appraisal system should be mainly linked to the quantitative elements of the credit institution's NPE targets but may also include qualitative elements (level of technical abilities relating to the analysis of financial information and data received, structuring of proposals, quality of recommendations or monitoring of restructured cases, as well as effective negotiation skills). The performance of the NPE WU staff shall be regularly monitored and measured against these targets either on an individual basis or at team level, as appropriate.

317. The performance measurement framework for the board of directors and relevant bank officials should include specific indicators linked to the targets defined in the credit institution's NPE strategy and operational plan. The weights given to these indicators within the overall performance measurement framework should be proportionate to the severity of the NPE issues faced by the credit institution.

318. Credit institutions shall encourage addressing early warnings signals and indicators through the remuneration policy and incentives framework in order to ensure that pre-arrears are efficiently addressed and NPE inflows thus effectively reduced.

4.2.2.5 Technical resources

319. In terms of adequate technical infrastructure, credit institutions shall ensure that all NPE-related data are centrally stored in robust and secure IT systems and that they are complete and up to date throughout the NPE workout process.

320. Credit institutions shall ensure that the technical infrastructure is adequate to enable NPE WUs to:

   a. Access all relevant data and documentation, including:

      i. current NPE and early arrears borrower information, including automated notifications;

      ii. exposure, collateral and guarantee information linked to the borrower or connected clients;

      iii. monitoring tools with the IT capabilities to track forbearance performance and effectiveness;

      iv. status of workout activities and borrower interaction, as well as details on forbearance measures agreed;

      v. foreclosed assets, where relevant;

      vi. racked cash flow of the loan and collateral;

      vii. sources of underlying information and complete underlying documentation;

      viii. where relevant, access to central credit registers, land registers and other external data sources.

   b. Efficiently process and monitor NPE workout activities, including:

      i. automated workflows throughout the entire NPE life cycle;

      ii. an automated monitoring process for loan status, ensuring correct flagging of NPEs and FBEs;

iii. incorporated warning signals;

iv. automated quantitative reporting throughout the NPE workout life cycle as a basis for the analyses to be provided to NPE WU management, the board of directors and other relevant managers, as well as the Authority;

v. performance analyses of workout activities by NPE WUs, sub-teams and experts;

vi. evolution monitoring of portfolios, sub-portfolios, cohorts and individual borrowers.

c. Define, analyse and measure NPEs and related borrowers:

i. recognise NPEs and measure impairments;

ii. perform suitable NPE portfolio analyses and store outcomes for each borrower;

iii. support the assessment of the borrower's personal data, financial position and repayment ability, at least for non-complex borrowers;

iv. conduct calculations of (i) the net present value and (ii) the impact on the capital position of the credit institution for each restructuring option and/or any likely restructuring plan under any relevant legislation (e.g. foreclosure law, insolvency law) for each borrower.

321. Credit institutions shall ensure that the adequacy of the technical infrastructure, including data quality, is assessed by an independent internal or external audit function on a regular basis.

4.2.3 Control framework

322. The board of directors shall be responsible for establishing and monitoring the adequacy and effectiveness of the internal control framework. In particular, effective and efficient internal control processes shall be implemented for the NPE workout

framework in order to ensure full alignment between the NPE strategy and operational plan on the one hand and the credit institution's overall business strategy, including the NPE strategy and operational plan, and risk appetite on the other hand.

323. Internal control functions should regularly submit to the board of directors written reports on NPE management highlighting major identified deficiencies. These reports should include, for each new identified major deficiency, the relevant risks involved, an impact assessment, recommendations and corrective measures to be taken. Where necessary, the heads of internal control functions should be able to have access to and report directly to the board of directors to raise concerns and warn the supervisory function, where appropriate, when specific developments affect or may affect the credit institution. This shall not prevent the heads of internal control functions from reporting within regular reporting lines as well.

324. The board of directors shall follow up on the findings of the internal control functions in a timely and effective manner and require adequate remedial actions. The credit institution shall put in place a formal follow-up procedure on findings and corrective measures taken.

325. The internal control framework shall involve all three lines of defence in line with the BR/24 on Internal Governance. The roles of the different functions involved shall be assigned and documented clearly to avoid gaps or overlaps. Key outcomes of second- and third-line activities as well as defined mitigating actions and progress on those needs shall be reported to the board of directors regularly.

326. In the implementation of the control framework, larger and more complex credit institutions (reference to Art.4(1)(146) of the CRR) should apply all three lines of defence; the second line of defence does not have to be NPE-specific and may be performed by the credit risk (control) function.

327. In the implementation of the control framework, smaller and less complex credit institutions (reference to Art.4(1)(145) of the CRR) do not necessarily have to have three fully fledged NPE-specific lines of defence, but they have to ensure that any conflict of interest is sufficiently mitigated.

4.2.3.1 First line of defence controls

328. Credit institutions shall ensure that the first line of defence is embedded into the procedures and processes of the operational units, mainly the NPE WUs, that actually own and manage the credit institution's risks in the specific context of NPE workout.

329. In order to ensure that adequate control mechanisms are implemented, credit institutions shall have internal policies in place on the NPE workout framework. The managers of the operational units are responsible for ensuring that these internal policies are implemented, including through their incorporation into IT procedures. Credit institutions shall implement the key elements of the NPE framework-related policies as set out in Annex 4 to these guidelines.

4.2.3.2 Second line of defence controls

330. Second line of defence functions shall perform controls on a continuous basis to check that NPE management in the first line of defence is operating as intended. To adequately perform their control tasks, second-line functions require a strong degree of independence from functions performing business activities, including the NPE WUs, and should have sufficient resources. They shall have an adequate number of qualified staff. The qualifications of staff shall be reassessed on an ongoing basis, and staff shall receive training as necessary.

331. The second line of defence controls the implementation of risk management measures by the NPE WUs and shall have a special focus on:
    a. monitoring and measuring of NPE-related risks on a granular and aggregate basis, including in relation to internal/regulatory capital adequacy;

    b. reviewing the performance of the overall NPE operating model, as well as elements of it;

    c. assuring quality across NPE loan processing, monitoring/reporting (internal and external), forbearance, impairments, write-offs, collateral valuation and NPE reporting (in order to fulfil this role, second-line functions shall have sufficient power to intervene ex ante on the implementation of individual workout solutions);

d. reviewing the alignment of NPE-related processes with internal policy and public guidance, most notably related to NPE classification, provisioning, write-offs, collateral valuations, forbearance and early warning mechanisms.

332. Risk control and compliance functions shall also provide guidance on the process of designing and reviewing NPE-related policies and procedures and on the controls being established across NPE WUs. These functions shall be involved in the design and review of the policies before they are approved by the board of directors.

4.2.3.3 Third line of defence controls

333. The third line of defence, the independent internal audit function, shall have sufficient NPE workout expertise to perform its periodic control activities on the efficiency and effectiveness of the NPE framework, including the first- and second-line controls.

334. With regard to the NPE framework, the internal audit function shall, at least, perform regular assessments to monitor adherence to internal NPE-related policies (see Annex 4) and to this Part of the Rule. This shall also include random and unannounced inspections and credit file reviews.

335. In determining the frequency, scope and scale of the controls to be carried out, credit institutions shall take into account the level of NPEs and whether significant irregularities and weaknesses have been identified by recent audits.

336. Based on the results of its controls, the internal audit function shall make recommendations to the board of directors, bringing possible improvements to their attention.

4.2.4 Monitoring of NPEs and NPE workout activities

337. Credit institutions shall base their monitoring systems on the NPE targets approved in the NPE strategy and related operational plan, which are subsequently cascaded down to the operational targets of the NPE WUs, with feedback loops to pricing of credit risk and provisioning. Credit institutions shall also develop a related framework of NPE-related key performance indicators (KPIs) to allow the board of directors and other bank officials to measure progress.

338. Credit institutions shall define and monitor NPE-related KPIs. The NPE-related KPIs, shall include, but not necessarily be limited to (see also Annex 2):

a. NPE metrics;

b. borrower engagement and cash collection;

c. forbearance activities;

d. liquidation activities;

e. other (such as NPE-related profit and loss items, foreclosed assets, outsourcing activities).

4.2.4.1 NPE metrics

339. Credit institutions shall closely monitor the relative and absolute levels of NPEs and FBEs, as well as foreclosed assets (or other assets stemming from NPE activities) and early arrears, in their books.

340. Credit institutions shall carry out such monitoring activities at transaction/borrower level, and portfolio or sub-portfolio levels, as appropriate, considering aspects such as business line, borrower segment, geographical area, products, concentration risk, level of collateralisation and type of collateral provided, and debt-service ability.

341. Credit institutions shall monitor the level of impairments of NPEs in order to provide the board of directors with comprehensive information on coverage. The analysis shall include data on the aggregate level as well as the levels for different NPE portfolios. The selection of NPE portfolios shall consider aspects such as type of exposure, including secured/unsecured, type of collateral and guarantees, geographical area, number of years since NPE classification, time to recovery, and the use of the going and gone concern approach. Coverage movements shall also be monitored and reductions clearly explained.

342. Credit institutions shall benchmark indicators related to the NPE ratio and coverage against the available indicators of peers in order to provide the board of directors with a clear picture of the competitive position and potential shortcomings.

343. Credit institutions shall monitor their deviations from the budget, in order for the board of directors to understand the drivers of significant deviations from the plan.

344. Key figures on NPE inflows and outflows should be included in periodic reporting to the board of directors, including transfers from or to NPEs, non-performing FBEs, NPEs under probation, performing FBEs and early arrears (less than 90 days past due).

345. Credit institutions shall consider if it is useful to establish migration matrices to track the flow of exposures into and out of non-performing classification.

346. Credit institutions shall estimate the migration rates and the quality of the performing exposures month by month, so that actions can be prioritised and taken promptly to inhibit deterioration of portfolio quality. Migration matrices can be further broken down by exposure type (retail mortgage, consumer, real estate), by business unit or by other subportfolio to identify whether the driver of the flows can be attributed to a specific subportfolio.

347. In their monitoring activities, credit institutions shall use internal information and external information (e.g. from rating agencies, credit bureaus, specialised sector research or macroeconomic indicators for specific geographical areas) and shall refer to a particular point in time or observation period. Annex 3 includes examples of such internal and external information.

4.2.4.2 Borrower engagement and cash collection

348. Once NPE WUs have been established, credit institutions shall implement key operational performance metrics to assess the units' or employees' efficiency relative to average performance and/or standard benchmark indicators. If no such indicators exist or are available, credit institutions shall monitor key operational performance by measuring the effective results against the targets set in the credit institution's NPE operational plan.

4.2.4.3 Forbearance activities

349. To resolve or limit the impact of NPEs, credit institutions shall explore the possibilities with regard to granting forbearance measures. Credit institutions shall monitor two aspects of the forbearance activities, namely efficiency and effectiveness.

Section 4.4 specifies the requirements relating to the application of forbearance measures.

350.The main objective of forbearance measures shall be the return of the borrower to a sustainable performing repayment status, taking into account the amount due and minimising expected losses. This objective shall take into account the importance of ensuring the fair treatment of consumers and compliance with any consumer protection requirements that may be applicable. Credit institutions shall monitor the quality of the forbearance activities to make sure that they are not used to delay impairments or an assessment that the exposure is uncollectable. The monitoring shall cover forbearance activities in relation to both performing and non-performing exposures.

4.2.4.4 Liquidation activities

351. If no sustainable restructuring solution can be reached, credit institutions shall still resolve the NPE. Resolution may involve initiating legal procedures, foreclosing assets, debt to asset/equity swap, disposal of credit facilities by sale, transferal to an asset management company or securitisation. Where the price obtained from the foreclosure of immovable property affects the amount owed by a consumer, credit institutions shall take into account, when deciding on the liquidation measure and next steps, the provisions of Regulation 21 of of the Credit Agreements for Consumers Relating to Residential Property Regulations (S.L. 378. 10) , to the extent applicable.

352.Credit institutions shall monitor liquidation activities to help inform the strategies and policies. Credit institutions shall monitor disposals and monitor realised sales/transfer prices against net carrying amounts.

353.Credit institutions shall monitor the volumes and recovery rates of legal and foreclosure cases. Performance in this regard shall be measured against set targets, in terms of number of months/years and loss to the credit institution. In monitoring the actual loss rate, credit institutions shall build historical time series for each loan portfolio to back up the assumptions used for impairment review purposes and stress test exercises.

354. For exposures covered by collateral or another type of guarantee, credit institutions shall monitor the time period needed to liquidate the collateral or to

enforce a guarantee. Credit institutions shall also monitor potential forced sale haircuts upon liquidation and developments in certain markets to obtain an outlook on potential recovery rates.

355. Monitoring the recovery rates from foreclosure and other legal proceedings shall help credit institutions to reliably assess whether the decision to foreclose will provide a higher net present value than pursuing a forbearance option. The data regarding the recovery rates from foreclosures shall be monitored on an ongoing basis and feed into potential amendments to credit institutions' strategies for handling their debt recovery/legal portfolios.

356. Credit institutions shall also monitor the average duration of legal procedures recently completed and the average amounts recovered (including related recovery costs) from these completed procedures.

357. Credit institutions shall carefully monitor cases where the debt is swapped with an asset or equity of the borrower, at least by using volume indicators by type of assets, and ensure compliance with any limits set by the relevant national regulations on holdings. Credit institutions shall make use of this approach as a forbearance measure when it is backed by a proper business plan and limited to assets in relation to which the credit institution has sufficient expertise and the market realistically allows the determined value to be extracted from the asset in the short to medium term. Credit institutions shall also make sure that the valuation of the assets is carried out by qualified and experienced appraisers.

4.2.4.5 Other monitoring items

358. Credit institutions shall monitor and report to the board of directors the amount of interest income stemming from NPEs. In addition, credit institutions shall make a distinction between the interest payments on NPEs actually received and those actually not received. The evolution of loss allowances and the related drivers shall also be monitored.

359. If foreclosure is a part of a credit institution's NPE strategy, the credit institution shall also monitor the volume, ageing, coverage and flows of foreclosed assets (or other assets stemming from NPEs) at a sufficient level of granularity to take into account material types of assets. The performance of the foreclosed assets vis-a-vis the

predefined business plan shall be monitored and reported to the board of directors and other bank officials on an aggregate level.

4.3 Forbearance

360. Credit institutions shall use the definitions of forbearance measures and FBEs as stated in Annex V to Commission Implementing Regulation (EU) No 451/2021 in their risk management. Forbearance measures shall be aimed to return the borrower to a sustainable performing repayment status, taking into account the amount due and minimising expected losses. When deciding on which steps or forbearance measures to take, credit institutions shall take into account the interests of consumers and comply with consumer protection requirements, including those set out in regulation 17C of the Credit Agreements for Consumers Relating to Residential Property Regulations (S.L. 378. 10) and in the EBA Guidelines on arrears and foreclosure (EBA/GL/2015/12). Credit institutions shall monitor the efficiency and effectiveness of forbearance activities.

361. This Part sets out the key elements of governance and operations in relation to FBEs.

4.3.1 Forbearance measures and their viability

362. Credit institutions shall consider using a combination of different forbearance measures, including both short-term and long-term time horizons in line with the nature and maturity of the credit facilities. Credit institutions shall consider the list of possible forbearance measures in Annex 5.

363. Credit institutions shall use forbearance measures with time horizons shorter than two years (one year in the case of project finance and the construction of commercial property) where such measures do not address the resolution of outstanding arrears, unless such measures are combined with forbearance measures that are longer than two years.

364. Credit institutions shall consider forbearance measures with time horizons not greater than two years (and, where appropriate, for other forbearance measures) when the borrower meets the following criteria:

   a. The borrower has experienced an identifiable event that has caused temporary liquidity constraints. Evidence of such an event shall be demonstrated in a formal manner with clear evidence showing that the borrower's income will recover fully

or mostly in the short term, or on the basis of the credit institution concluding that a long-term forbearance solution was not possible due to temporary financial uncertainty of a general or borrower specific nature. The form of evidence to be provided to the credit institution for this purpose shall be proportionate to the nature, maturity and value of the credit facility in question.

b. The borrower had been fulfilling contractual obligations prior to the event.

c. The borrower has clearly demonstrated willingness to cooperate with the credit institution.

365. The credit institution shall ensure that the contractual terms for any forbearance measure allow the credit institution the right to review the agreed forbearance measures if the situation of the borrower improves and more favourable conditions for the credit institution (with regard to the forbearance or the original contractual conditions) can therefore be enforced; to this end, the contract shall indicate the specific changes to the forbearance measure to be applied as a consequence of specific improvements in the situation of the borrower. Credit institutions shall also consider including strict consequences, such as a requirement for additional collateral, in the contractual terms for borrowers who fail to comply with the forbearance agreement

4.3.2 Viable versus non-viable forbearance

366. Credit institutions shall distinguish between viable forbearance measures contributing to reducing the borrower's exposure and non-viable forbearance measures.

367. Credit institutions shall consider the following factors when assessing the viability of forbearance measures:

a. Demonstrate (based on objectively verifiable evidence) that the borrower can afford the forbearance solution, i.e. full repayment is expected.

b. The resolution of outstanding arrears is fully or mostly addressed and a significant reduction in the borrower's balance in the medium to long term is expected.

c. In cases where previous forbearance measures have been granted, including any previous forbearance measures considered in the long run, the credit institution

should ensure that additional internal controls are implemented to ensure that this subsequent forbearance treatment meets the viability criteria outlined below. These controls should include, at a minimum, that such cases are explicitly brought to the attention of the risk control function ex ante. Furthermore, the explicit approval of the relevant senior decision-making body should be sought.

d. Forbearance measures with a short-term time horizon are applied temporarily and the credit institution is able to demonstrate, based on objectively verifiable evidence, that the borrower has the ability to repay the original or modified amount on a full principal and interest basis commencing from the expiry date of the short-term temporary arrangement.

e. The measure does not result in multiple consecutive forbearance measures having been granted to the same exposure.

368.The assessment of viability shall be based on the financial characteristics of the borrower and the forbearance measure to be granted at that time. The viability assessment shall take place irrespective of the source of forbearance. Different sources for forbearance measures are, inter alia, the borrower using a forbearance clause embedded in a contract, bilateral negotiation of forbearance between a borrower and a credit institution and a public forbearance scheme extended to all borrowers in a specific situation.

4.3.3 Sound forbearance processes

4.3.3.1 Forbearance policy

369.Credit institutions shall develop a policy on their forbearance activities. The policy shall cover at least:

a. the process and procedures for granting forbearance measures, including responsibilities and decision-making;

b. a description of available forbearance measures, including those embedded in contracts;

c. information requirements for assessing the viability of forbearance measures;

d. documentation of forbearance measures granted;

e. the process and metrics for monitoring the efficiency and effectiveness of forbearance measures.

370. Credit institutions shall regularly review their forbearance policies and options based on the collective monitoring of the performance of different forbearance measures, including the examination of potential causes and instances of re-defaults.

4.3.3.2 Efficiency and effectiveness of forbearance activities

371. Credit institutions shall monitor the quality of forbearance activities to make sure that they are not used to delay an assessment that the exposure is uncollectable. The monitoring shall cover forbearance activities relating to both performing and non-performing exposures and differentiate between types of forbearance measures and portfolios.

372. Credit institutions shall measure the efficiency of the process for granting forbearance measures and monitor the duration of the decision-making process and the volumes of forbearance measures at each stage of the granting process.

373. Credit institutions shall monitor effectiveness of forbearance measures granted. This monitoring shall measure the degree of success of the forbearance measure and whether the modified contractual obligations of the borrower are met and the exposure is performing. Credit institutions shall make use of the following metrics by portfolio and by type of forbearance measure:

a. Forbearance cure rate and rate of exposure being reclassified as non-performing: credit institutions shall conduct a vintage analysis and monitor the behaviour of FBEs from the date of modification to determine the cure rate. This analysis shall be conducted separately for cured exposures with and without forbearance measures.

b. Cash collection rate: credit institutions shall monitor cash collected from FBEs.

c. Write-off: where granting a forbearance measure leads to a partial write-off, credit institutions shall record and monitor these exposures against an approved loss budget. The net present value loss associated with the decision to write off an unrecoverable exposure should be monitored against the cure rate.

374. Credit institutions shall monitor indicators relating to forbearance activities using a meaningful breakdown, which could include the type and duration of arrears, the type of exposure, the probability of recovery, the size of the exposures or the total amount of exposures to the same borrower or group of connected clients, and the number of forbearance solutions applied in the past.

4.3.3.3 Assessing the borrower's repayment capacity

375. Credit institutions shall assess the borrower's repayment capacity before granting any forbearance measures. This assessment shall include an adequate assessment of the borrower's financial situation, based on sufficient information and taking into account relevant factors such as the debt-servicing capacity and overall indebtedness of the borrower or the property/project.

4.3.3.4 Standardised forbearance products and decision trees

376. Credit institutions shall have in place adequate policies and procedures with a range of sustainable and effective solutions for the borrower when granting forbearance. The grouping of exposures into portfolios shall be reflected in these policies and procedures, to enable credit institutions to adopt different forbearance measures for different segments of borrowers and tailor measures to them.
377. Credit institutions shall consider developing decision trees and standardised forbearance measures for portfolios of homogeneous borrowers with less complex exposures. Decision trees may help in determining and implementing appropriate and sustainable forbearance strategies for specific portfolios of borrowers in a consistent manner based on approved criteria.

4.3.3.5 Comparison with other NPE workout options

378. Credit institutions shall use a net present value approach to determine the most suitable and sustainable workout option for borrowers' varied circumstances, having regard to the fair treatment of the consumer, and should compare the net present value of the envisaged forbearance measure with the net present value of repossession and other available liquidation options. The parameters used in the calculation, such as the assumed liquidation time horizon, discount rate, cost of capital and liquidation cost, shall be based on observed empirical data.

4.3.3.6 Forbearance targets and monitoring

379. Forbearance contracts and documentation shall include a well-defined borrower target schedule, detailing all necessary targets to be achieved by the borrower in order to repay the exposure over the course of the contract term. These milestones/targets shall be credible, appropriately conservative and take account of any potential deterioration in the borrower's financial situation. The NPE WU responsible for granting the forbearance shall closely monitor the performance of the forborne borrower, including the borrower's compliance with all agreed targets, at least for the duration of the probation period.

4.4 NPE recognition

380. Credit institutions shall use the definition of NPE in Annex V to Commission Implementing Regulation (EU) No 451/2021 in their risk management.

381. This Part sets out the key elements of governance and operations in relation to NPE recognition.

4.4.1 Past due criterion

382. Credit institutions shall recognise exposures as being past due in accordance with Part 2 of this Rule and paragraph 45 of this Rule.

4.4.2 Indications of unlikeliness to pay

383. Credit institutions should recognise exposures as unlikely to pay and identify indications of unlikeliness to pay in accordance with section 2.2.2 of this Rule.

384. Credit institutions shall monitor the repayment capacity of borrowers. In the case of corporate borrowers, credit institutions shall carry out such assessment at least annually and at key reporting dates at which financial data are available. Credit institutions shall collect the latest financial information from corporate borrowers in a timely fashion. The non-provision or the unreasonably late provision of information may be seen as a negative sign with regard to the borrower's creditworthiness. In the case of non-corporate borrowers, credit institutions shall monitor payment performance and any signs of financial difficulties that may have an impact on repayment capacity. For borrowers on a watch list or with a weak rating, credit institutions shall have in place more frequent review processes, depending on the

materiality, the portfolio and the borrower's financial standing. The regular assessment of the borrower's repayment capabilities shall also apply to bullet loans, because these loans represent a higher level of risk than a loan subject to regular amortisation and also because continuous payment by the borrower of the interest amounts due is not sufficient reason to assume that the final bullet repayment of the loan will take place.

4.4.3 Forbearance and performing status

4.4.3.1 Forbearance

385. For the purpose of implementing forbearance measures, credit institutions shall be able to identify signs of possible future financial difficulties at an early stage. In order to do so, the assessment of the financial situation of the borrower shall not be limited to exposures with apparent signs of financial difficulties. Credit institutions shall also conduct an assessment of financial difficulties for exposures for which the borrower does not have apparent financial difficulties but for which the market conditions have changed significantly in a way that could impact the borrower's ability to repay.

386. The assessment of any financial difficulties on the part of a borrower shall be based on the situation of the borrower only, disregarding collateral or any guarantees provided by third parties. When assessing the financial difficulties of the borrower, credit institutions shall, in accordance with Annex V to Commission Implementing Regulation (EU) No 451/2021, consider at least the following rebuttable circumstances:

    a. borrower/facility more than 30 days past due during the three months prior to its modification or refinancing;

    b. increase in probability of default (PD) of credit institution's internal rating class during the three months prior to its modification or refinancing;

    c. presence on a watch list during the three months prior to its modification or refinancing.

387. Credit institutions shall not identify exposures as forborne when concessions are made to borrowers who are not in financial difficulties. Credit institutions shall distinguish, based on a detailed financial assessment, between renegotiations or rollovers granted to borrowers not in financial difficulties and forbearance measures

such as concessions granted to borrowers in financial difficulties, in accordance with Annex V to Commission Implementing Regulation (EU) No 451/2021.

388. Granting new conditions such as a new interest rate more favourable than the rate borrowers with a similar risk profile could obtain, may be considered an indication of such a concession, when the credit institution determines that the reason for the new rate is the financial difficulties of the borrower. The provision of more favourable new conditions than those practised by the market shall not be considered a prerequisite for the identification of concessions and therefore forbearance. In line with Annex V to Commission Implementing Regulation (EU) No 451/2021, when a borrower is in financial difficulties, a change in conditions in line with what other borrowers with a similar risk profile could get from the credit institution shall qualify as a concession, including when borrowers are included in public forbearance schemes that are offered by credit institutions.

389. Borrowers may request modifications in the contractual conditions of their loans without facing or being about to face difficulties in meeting their financial commitments. Credit institutions shall perform an assessment of the borrower's financial situation when such modifications to contractual conditions have an impact on payment performance.

4.4.3.2 Classification of FBEs as non-performing

390. When granting forbearance measures to performing exposures, credit institutions shall assess whether these measures lead to a need to reclassify the exposure as non-performing. Granting forbearance measures to NPEs does not clear their non-performing status: the exposures shall continue to be identified as non-performing for at least one year of the cure period after the granting of the forbearance measures, as specified in Annex V to Commission Implementing Regulation (EU) No 451/2021 and in Section 4.4.3.2.

391. When assessing if FBEs should be classified as non-performing, credit institutions shall assess if exposures:

a. are supported by inadequate payment plans (either initial or subsequent payment plans, as applicable) that encompass, inter alia, a repeated failure to comply with the payment plan, changes to the payment plan to avoid breaches or the payment plan's resting on expectations that are not supported by

macroeconomic forecasts or by credible assumptions on the repayment capability or willingness of the borrower;

b. include contract terms that delay the time for the regular repayment instalments on the transaction, in such a way that its assessment for a proper classification is hindered, such as when grace periods of more than two years for the repayment of the principal are granted;

c. include de-recognised amounts that exceed the accumulated credit risk losses for NPEs with a similar risk profile.

4.4.3.3 Cure/exit from non-performing status

392. Credit institutions shall reclassify NPEs, including FBEs, as performing in accordance with Annex V to Commission Implementing Regulation (EU) No 451/2021. Credit institutions shall perform a financial analysis of the borrower to establish the absence of concerns regarding the borrower's ability to pay its credit obligations.

393. Credit institutions shall specify in their policies for the reclassification of non-performing FBEs, the practices for dispelling concerns regarding the borrower's ability to comply with the post forbearance conditions set out in Annex V to Commission Implementing Regulation (EU) No 451/2021. Credit institutions shall establish in such polices the criteria in terms of payments made during the cure period of at least one year and define the borrower's ability to comply with post-forbearance conditions (to the extent that full repayment of the debt is likely) without being reliant on the realisation of collateral at least by demonstrating payments of a not insignificant amount of principal. These policies shall require payments of both principal and interest.

394. In addition, where a borrower has other exposures to a credit institution that are not the subject of a forbearance measure, the credit institution shall consider the impact and the performance of these exposures in its assessment of the borrower's ability to comply with post-forbearance conditions. The consideration of arrears shall not change the level of application of non-performing status, in accordance with Annex V to Commission Implementing Regulation (EU) No 451/2021, and only exposures to which forbearance measures have been applied shall be identified as FBEs.

395. The existence of contract terms that extend the repayment period, such as grace periods for the principal, shall confirm the classification of these FBEs as non-performing until the requirements of Annex V to Commission Implementing Regulation (EU) No 451/2021 have been satisfied. The fact that the one-year cure period has elapsed shall not automatically lead to reclassification to performing unless regular payments have been made over these twelve months and an assessment of unlikeliness to pay has been concluded with no indication of unlikeliness to pay.

4.4.3.4 Identification of exposures as performing FBEs

396. Once FBEs are classified as performing, either because they have met the conditions for being reclassified from the non-performing category or because the granting of forbearance measures did not lead to the classification of the exposure as non-performing, they shall continue to be identified as forborne until all the conditions for the discontinuation of the classification of exposures as forborne under paragraph 256 of Annex V to Commission Implementing Regulation (EU) No 451/2021 have been met.

397. Credit institutions' policies for identifying performing FBEs shall specify practices for dispelling concerns regarding the borrower's financial difficulties. Credit institutions' policies shall require the borrower to have settled, by means of regular payments, an amount equal to all the amounts (principal and interest) that were previously past due or de-recognised at the time of the concession, or to otherwise demonstrate its ability to comply with the post-forbearance conditions under alternative objective criteria that include a repayment of principal.

398. In accordance with paragraph 260 of Annex V to Commission Implementing Regulation (EU) No 451/2021, new forbearance measures granted to performing FBEs that have been reclassified out of the non-performing category will entail the reclassification of these transactions to the non-performing category. The same shall apply when these exposures become more than 30 days past due.

4.4.4 Consistent application of definition of non-performing

399. Credit institutions shall adopt adequate mechanisms and procedures, in accordance with section 2.4 of this Rule on the definition of default, for the harmonised

implementation of the definition in all subsidiaries and branches. This will ensure that the identification of NPEs is consistent at entity and banking group levels.

400. Credit institutions shall ensure that their policies provide a consistent treatment of individual clients and groups of connected clients as defined in the CRR, the EBA Guidelines on connected clients (Annex 6 of this Rule) and Part 2 of this Rule. Credit institutions shall also ensure that their policies provide a consistent assessment of the underlying legal relationships between legal entities across a group of connected clients. In view of possible contagion, credit institutions shall, whenever feasible, apply a group perspective when assessing the status of a borrower's exposure as non-performing, unless it is affected by isolated disputes that are unrelated to the solvency of the counterparty.

401. In accordance with the Part 2 of this Rule, credit institutions shall keep a register of all classification criteria.

4.5 NPE impairment and write-offs

402. Credit institutions shall estimate loss allowances for NPEs and FBEs subject to impairment in accordance with Part 3 of this Rule.

403. This section sets out the key elements of governance and operations in relation to NPE impairment measurement and write-offs.

4.5.1 NPE write-offs

404. In accordance with Part 3 of this Rule, credit institutions shall recognise uncollectability in the appropriate period through loss allowances or write-offs. When credit institutions have no reasonable expectation of recovering contractual cash flow of the exposure, this shall lead to a partial or full write-off of the exposure as per IFRS 9.B3.2.16.r.

405. A write-off may be done before legal actions against the borrower to recover the debt have been concluded in full. A write-off shall not be considered to mean that the credit institution has forfeited the legal right to recover the debt; a credit institution's decision to forfeit the legal claim on the debt is debt forgiveness.

406. Write-offs constitute a de-recognition event as per IFRS 9.5.4.4. If cash or other assets are eventually collected, these collections shall be directly recognised as income in the statement of profit or loss.

407. Credit institutions shall maintain detailed records of all NPE write-offs performed on a portfolio-level basis.

4.5.2 NPE impairment and write-offs

408. Credit institutions shall include in their internal policies guidance on the timeliness of impairments and write-offs, acknowledging external circumstances and factors such as ongoing judicial procedures. In particular for exposures or parts of exposures that are not covered by collateral, credit institutions shall consider suitable maximum periods for full impairment, coverage and write-off. For parts of exposures covered by collateral, the establishment of a minimum impairment level shall take the type of collateral into account. Empirical evidence shall be applied when calibrating the impairment and write-off periods referred to above. When assessing the recoverability of NPEs and in determining internal NPE write-off approaches, credit institutions shall pay particular attention to the cohorts listed below, as these may have higher levels of permanent uncollectability.

    a. Exposures with prolonged arrears: different thresholds may be appropriate for different portfolios. Credit institutions shall assess the recoverability of NPEs if the borrower has been in arrears for a prolonged period of time. If, following this assessment, the credit institutions concludes that there is no reasonable expectation of recovering an exposure or part of an exposure, a full or partial write-off shall be performed.

    b. Exposures under an insolvency procedure: where the collateralisation of the exposure is low, legal expenses often absorb a significant portion of the proceeds from the bankruptcy procedure, and therefore estimated recoveries can be expected to be very low.

    c. A partial write-off may be justified when there is evidence that the borrower is unable to repay the amount of the exposure in full, meaning that there is a reasonable expectation of recovering a part of the exposure.

4.5.3 Impairment and write-off procedures

409. Credit institutions shall adopt, document and adhere to sound policies, procedures and controls for assessing and measuring loss allowances and write-off on NPEs in accordance with Part 3 of this Rule. Credit institutions shall back-test their loss allowance estimations against actual losses.

410. Credit institutions shall include in such methodologies, policies and procedures on write-offs and recoveries as defined in Part 3 of this Rule. The policy on write-offs shall include indicators used to assess expectations of recovery and detailed information on those exposures that have been written off but are still subject to enforcement activity.

411. In accordance with Part 3 of this Rule, credit institutions shall have in place common processes, systems, tools and data.

412. A credit institution's internal audit function shall verify the methodologies used in accordance with Banking Rule 24 on Internal Governance.

4.6 Collateral valuation of immovable and movable property

413. This section sets out the key elements for collateral valuation of immovable and movable property pledged for NPEs.

4.6.1 Governance, procedures and controls

4.6.1.1 General policy and procedures

414. Credit institutions shall have in place a written policy and procedures governing the valuation of property collateral. Credit institutions shall ensure that such policy and procedures are fully aligned with the credit institution's RAF.

415. Credit institutions shall also ensure that the policy and procedures cover the valuation of all immovable and movable property collateral irrespective of its eligibility for prudential purposes in accordance with the requirements of Article 208 and Article 210 of the CRR.

416. The board of directors shall approve and review, at least, on an annual basis, such policy and procedures as referred to in paragraph 415.

4.6.1.2 Monitoring and controls

417. Credit institutions shall monitor and review the valuations performed by internal or external appraisers on a regular basis as set out in this section.

418. Credit institutions shall develop and implement a robust internal quality assurance policy and procedures for valuations conducted internally and externally, taking into consideration the following:
    a. The quality assurance process shall be carried out by a function that is independent from the function conducting the initial valuation, loan processing, loan monitoring and the underwriting process.

    b. The independence of the external appraiser selection process shall be tested on a regular basis as part of the quality assurance process.

    c. An appropriate, similar sample of internal and external valuations shall be compared with market observations on a regular basis.

    d. Back-testing of both internal and external valuations shall be carried out on a regular basis.

    e. The quality assurance process shall be based on an appropriate sample size.

419. In addition, the credit institution shall ensure that the internal audit function regularly reviews the consistency and quality of the valuation policy and procedures, the independence of the appraiser selection process and the appropriateness of the valuations carried out by both external and internal appraisers.

4.6.1.3 Individual valuation of immovable property and use of indexation

420. Credit institutions shall monitor the value of immovable property collateral on a frequent basis and at a minimum as specified in Article 208(3) of the CRR.

421. Credit institutions may make use of indexation or similar methods to monitor the value of a collateral and identify the collaterals requiring revaluation. This shall be in

line with the credit institution's policy and provided that the collateral to be assessed is susceptible to accurate assessment by such methods.

422. Credit institutions shall ensure that indices that are used to carry out this indexation may be internal or external as long as they are:

a. reviewed regularly, with the results of this review being documented and readily available, and with the review cycle and governance requirements being clearly defined in a policy document approved by the board of directors;

b. sufficiently granular, with the methodology being adequate and appropriate for the type of collateral in question;

c. based on a sufficient time series of observed empirical evidence of actual property transactions.

423. Credit institutions shall perform valuations and revaluations of immovable property collateral on an individual and a property-specific basis. Valuations and revaluations of immovable property collateral shall not be carried out using a statistical model as the sole means of undertaking the review of the property valuation.

424. For the purpose of this Rule, the Authority is hereby guiding institutions to a threshold of EUR 300,000 to apply for individual valuation and revaluation of the collaterals that are used for NPEs by an independent appraiser. Should banks deviate from such NPL guidance, the bank is required to explain and substantiate any deviations to the competent authority.

4.6.1.4 Appraisers

425. Credit institutions shall ensure that all valuations of immovable property, including updated valuations, are performed by an independent and qualified appraiser, internal or external, who possesses the necessary qualifications, ability and experience to execute a valuation, as specified in Article 208(3)(b) of the CRR.

426. For the purposes of external appraisals, credit institutions shall establish a panel of independent and qualified appraisers, based on the criteria set out below. Credit institutions shall assess the appraisers' performance on an ongoing basis and a

decision shall be made about whether each appraiser shall remain in the panel or not.

427. Credit institutions shall ensure that external appraisers on the panel have adequate and valid professional indemnity insurance.

428. The credit institution shall ensure that each qualified appraiser on the panel:

a. is professionally competent and has at least the minimum educational level that meets any national requirements for carrying out such valuations;

b. has appropriate technical skills and experience to perform the assignment;

c. is familiar with, and able to demonstrate ability to comply with, any laws, regulations and property valuation standards that apply to the appraiser and the assignment;

d. has the necessary knowledge of the subject of the valuation, the relevant property market and the purpose of the valuation.

429. The panel of appraisers shall contain expertise in various areas of the property sector appropriate to the lending business of the credit institution and the location of lending.

430. In order to mitigate any conflict of interest sufficiently, credit institutions shall ensure that all internal and external appraisers who are going to carry out the actual appraisal of a given property and their first-degree relatives meet the following requirements:

a. They are not involved in the loan processing, loan decision or credit underwriting process.

b. They are not guided or influenced by the borrower’s creditworthiness.

c. They do not have an actual or potential, current or prospective conflict of interest regarding the result of the valuation.

d. They do not have an interest in the property.

e. They are not a connected person to either the buyer or the seller of the property.

f. They provide an impartial, clear, transparent and objective valuation report.

g. The fee they receive is not linked to the result of the valuation.

431. Credit institutions shall ensure adequate rotation of appraisers, i.e. two sequential individual valuations of the immovable property by the same appraiser shall result in the rotation of the appraiser, resulting in the appointment of either a different internal appraiser or a different external appraisal provider.

4.6.2 Frequency of valuations

432. For prudential purposes, credit institutions shall update valuations of all secured exposures in accordance with the requirements of Article 208(3) and Article 210(c) of the CRR.

433. Credit institutions shall ensure that the group of collaterals that are subject to individual valuations and revaluations on a regular basis shall be updated at the time when the exposure is classified as non-performing and at least annually while it continues to be classified as such. Credit institutions shall make sure that, for the collateral subject to indexation or other similar methods, the indexation is updated at least annually.

434. For properties with an updated individual valuation that has taken place within the past 12 months (in line with all the applicable principles and requirements as set out in this section), the property value may be indexed up to the period of the impairment review.

435. Credit institutions shall carry out more frequent monitoring where the market is subject to significant negative changes and/or where there are signs of significant decline in the value of the individual collateral.

436. Therefore, credit institutions shall define criteria in their collateral valuation policy and procedures for determining if a significant decline in collateral value has taken place. Where possible, these shall include quantitative thresholds for each type of collateral, based on the observed empirical data and any relevant qualitative credit institution experience, bearing in mind relevant factors such as market price trends or the opinion of independent appraisers.

437. Credit institutions shall have appropriate processes and systems in place to flag outdated valuations and to trigger valuation reports.

4.6.3 Valuation methodology

4.6.3.1 General considerations

438. Credit institutions shall have in place defined collateral valuation approaches for each collateral product type which shall be adequate and appropriate to the type of collateral in question.

439. All immovable property collateral shall be valued on the basis of market value or mortgage lending value, as specified under Article 229 of the CRR. Movable property shall be valued at its market value.

440. For movable property, credit institutions shall, in accordance with the requirements of Article 199(6) of the CRR, periodically assess the liquidity of the property. If there is material volatility in the market prices, the credit institution shall demonstrate that the valuation of the collateral is sufficiently conservative.

441. For movable property, credit institutions shall, in accordance with the requirements of Article 210 of the CRR, conduct a sufficient legal review confirming the enforceability of the collateral, including an assessment of the legal right to enforce and liquidate the collateral in the event of default, within a reasonable timeframe.

442. Overall valuations based only on the discounted replacement cost shall not be used. For income-generating properties, a market-comparable or discounted cash flow approach can be used.

443. Property collateral shall be valued in accordance with applicable international, European and national standards.[20]

4.6.3.2 Expected future cash flow

444. Credit institutions shall estimate discounted cash flow in a prudential manner and in line with applicable accounting standards.

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[20] These include, but not limited to, the European Valuation Standards EVS-2016 (the Blue Book) and the Royal Institute of Chartered Surveyors (RICS) standards.

445. When calculating discounted cash flow, credit institutions shall take into account cases where:

a. the operating cash flow of the borrower continues and can be used to repay the financial debt, and collateral may be exercised to the extent that it does not influence operating cash flow; and

b. the operating cash flow of the borrower ceases and collateral is exercised.

446. When the estimation is based on the assumption that the operating cash flow of the borrower will continue, including cash flow being received from the collateral, updated and reliable information on cash flow is required.

447. When the estimation is based on the assumption that the operating cash flow of the borrower will cease, the future sale proceeds from collateral execution shall be adjusted to take into account the appropriate liquidation costs and market price discount.

448. In addition to the above liquidation costs, a market price discount, if appropriate, shall be applied to the updated valuation as outlined below.

449. The property price at the time of liquidation shall take into account current and expected market conditions.

450. Time-to-sale considerations in connection with the disposal of mortgaged properties should also be included, based on debt enforcement practices and experiences from judicial proceedings at national level and on empirical evidence, and back-tested accordingly. These considerations shall include any operational costs or capital expenditures to be incurred before the time of sale.

451. The execution of collateral may include both consensual and non-consensual (forced) liquidation strategies.

452. The liquidation cost discount shall reflect the manner of collateral execution, i.e. whether it is consensual or non-consensual.

453. The market price discount shall reflect the liquidity of the market and the liquidation strategy. It shall not reflect fire sale conditions unless the anticipated liquidation strategy actually involves a fire sale.

454. Credit institutions shall apply adequate market price discounts for the purposes of IFRS 9, for the calculation of regulatory capital and for risk control purposes. A market price discount may be close to zero only for highly liquid and non-distressed collateral types that are not affected by any significant correlation risks.

455. Credit institutions shall develop their own liquidation cost and market price discount assumptions based on observed empirical evidence. If insufficient empirical evidence is available, discount assumptions shall be based on, at a minimum, liquidity, passage of time, and the quality/ageing of the appraisal. If a credit institution faces the situation of a frozen property market and only a small number of properties have been sold or the sales history has to be considered insufficient, a more conservative market price discount shall apply.

4.6.4 Further considerations on estimating cash flow from property collateral liquidation

456. When estimating cash flow from property collateral liquidation, credit institutions shall use appropriate and credible assumptions. In addition, credit institutions shall pay attention to the requirements for valuing cash flow under IFRS 13 on fair value measurements. In particular, credit institutions shall comply with the following requirements:

a. They must determine the assumed time of disposal taking into account current and expected market conditions as well as the underlying national legal framework regarding the disposal of mortgaged properties.

b. They must ensure that the property price used to determine the estimated market value of property collateral at the point of liquidation is not based on macroeconomic projections/assumptions that are more optimistic than the projections produced by the relevant authorities and organisations such as International Monetary Fund (IMF) and the European System of Central Banks (ESCB)/ the European Systemic Risk Board (ESRB), and therefore does not assume an improvement on the current market conditions.

c. They must ensure that income from property collateral is not assumed to increase from the current levels unless there is an existing contractual arrangement for such an increase. Moreover, current income from property shall be adjusted when calculating cash flow in order to reflect the expected economic conditions. Credit institutions shall consider whether it is appropriate to project a flat income in a recessionary environment in which vacant properties are increasing and/or demand for transportation is decreasing, putting downwards pressure on income.

d. A hold strategy on property collateral is not acceptable. A hold strategy is defined as holding the asset at above market value assuming that the asset will be sold after the market recovers.

457. When using the value of collateral in assessing the recoverable amount of the exposure, credit institutions shall document at least the following:

a. how the value was determined, including the use of appraisals, valuation assumptions and calculations;

b. the supporting rationale for adjustments to appraised values, if any;

c. the determination of selling costs, if applicable;

d. the assumed timeline to recover;

e. the expertise and independence of the appraiser.

458. When the observable market price is used to assess the recoverable amount of the exposure, the credit institution shall also document the amount, source and date of the observable market price.

459. Credit institutions shall be able to substantiate the assumptions used when assessing the recoverable amount by providing to the Authority, if requested, details on the property market value, the market price discount, legal and selling expenses applied, and the term used for the time to liquidation. Credit institutions shall be able to fully justify their assumptions, both qualitatively and quantitatively, and explain the drivers of their expectations, taking past and current experience into account.

4.6.5 Back-testing

460. Credit institutions shall demonstrate via sound back-testing that the assumptions used when assessing the recoverable amount were reasonable and grounded in observed experience. In this context, credit institutions shall regularly back-test their valuation history (last valuation before the exposure was classified as non-performing) against their sales history (net sales price of collateral). Depending on the size and business model of the credit institution, it shall differentiate by collateral type, valuation model/approach, type of sale (voluntary/forced) and region for its back-testing process. The back-testing results shall be used to determine haircuts on collateral valuations supporting exposures remaining on the balance sheet.

4.6.6 IT database requirements in respect of collateral

461. Credit institutions shall have databases of transactions to enable the proper assessment, monitoring and control of credit risk, to respond to requests from management and the Authority, and to enable the provision of information in periodic reports and other timely and comprehensive documentation. In particular, databases shall comply with the following requirements:
    a. sufficient depth and breadth, in that they cover all the significant risk factors;

    b. accuracy, integrity, reliability and timeliness of data;

    c. consistency – they should be based on common sources of information and uniform definitions of the concepts used for credit risk control;

    d. traceability, such that the source of information can be identified.

462. These databases shall include all the relevant information on properties and other collateral for the credit institutions' transactions and on the links between collateral and specific transactions.

4.6.7 Valuation of foreclosed assets

463. Credit institutions shall strongly consider classifying foreclosed assets as non-current assets held for sale under IFRS 5. This accounting treatment implies that the asset must be available for immediate sale in its present condition (IFRS 5.7), that the board of directors shall approve an individual plan to sell the asset within a short

timeframe (normally one year) and that an active sales policy shall be pursued (IFRS 5.8); thus, it favours recoveries.

464. Foreclosed assets received shall be valued at the lower of:

a. the amount of the financial assets applied, treating the asset foreclosed or received in payment of debt as collateral;

b. the fair value of the repossessed asset, less selling costs.

465. When fair value is not obtained by reference to an active market but it is based on a valuation technique, some adjustments are necessary, in particular as a result of two factors:

a. The condition or location of the assets. Risk and uncertainty regarding the asset shall be incorporated in the fair value estimation.

b. The volume or level of activity of the markets in relation to these assets. The credit institution's previous experience in realisations and of the differences between amounts arrived at using the valuation technique and the final amounts obtained in realisations shall be incorporated into the calculation. The assumptions made in order to measure this adjustment may be documented, and shall be available to the supervisor on request. Illiquidity discounts may be considered.

466. When credit institutions' foreclosed assets are still under construction and it is decided to complete construction before selling the asset, credit institutions shall demonstrate the merits of such a strategy and the cost shall not exceed the fair value less costs to complete and sell the asset taking into account an appropriate illiquidity discount as described above.

467. When a foreclosed asset has exceeded the average holding period for similar assets for which active sales policies are in place, credit institutions shall revise the illiquidity discount applied in the valuation process described above, increase it accordingly. In these circumstances, credit institutions shall refrain from recognising write-backs/reversals of existing accumulated impairment on the asset, as its prolonged presence on the balance sheet provides evidence that the credit institution is unable to sell the asset at an increased valuation.

468. The frequency of valuation of foreclosed assets and the applicable procedures shall follow the treatment of immovable property as set out in Sections 4.6.1.2 and 4.6.2.

PART 5 – DISCLOSLURES OF NON-PERFORMING AND FORBONE EXPOSURES

5.1 Disclosures

469. Pillar 3 disclosures are considered an important tool to reinforce the appropriate market discipline by credit institutions. As required under Part Eight of the CRR, credit institutions are obliged to disclose information according to their classification. Disclosure requirements relating to non-performing and forborne exposures are also captured within this framework.

5.2 Disclosures mandated by the CRR

470. Commission Implementing Regulation (EU) 2021/637[21] defines the exact methodology to be used interalia for disclosures of non-performing and forborne exposures in respect to those institutions that are classified as 'large' and 'other' by the CRR. Nonetheless, in the case of 'other' institutions, such Regulation limits these disclosures solely to those entities which are listed. Credit institutions falling under scope shall adhere to these obligations and disclose the applicable templates as necessary.

5.3 Disclosures mandated by the consolidated EBA Guidelines on disclosure of non-performing and forborne exposures (EBA/GL/2018/10)

471. Credit institutions which are not in scope for disclosures related to non-performing and forborne exposures under the CRR are to adhere and implement the requirements, and any changes thereof, emanating from the consolidated EBA Guidelines on disclosure of non-performing and forborne exposures (EBA/GL/2018/10). Thus, as per scope of this Guideline, credit institutions which are not listed and fall under the categorisation of 'other', and 'small and non-complex institutions' (SNCIs) as defined by the CRR which are listed, are obliged to disclose information on this area by using the applicable templates found in the mentioned EBA Guidelines. Non-listed SNCIs are exempted from such disclosure requirements.

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[21] Commission Implementing Regulation (EU) 2021/637 of 15 March 2021 laying down implementing technical standards with regard to public disclosures by institutions of the information referred to in Titles II and III of Part Eight of Regulation (EU) No 575/2013 of the European Parliament and of the Council and repealing Commission Implementing Regulation (EU) No 1423/2013, Commission Delegated Regulation (EU) 2015/1555, Commission Implementing Regulation (EU) 2016/200 and Commission Delegated Regulation (EU) 2017/2295.

Annex 1 – Sample criteria for grouping retail NPEs

1. Natural or legal person:
   a. retail borrower
   b. sole trader
   c. small business or group of professionals
   d. SME (overlaps with corporates).

2. Arrears bucket/days past due (dpd) (the higher the level of arrears the narrower the range of possible solutions):
   a. early arrears (> 1 dpd and ≤ 90 dpd)
   b. late arrears (> 90 dpd and < 180 dpd)
   c. debt recovery unit (> 180 dpd, including also legal cases (borrowers in relation to whom legal actions have taken place or are in progress)).

3. Re-restructured cases (restructured loans with arrears, indicative of persistent repayment problems and/or failure of restructuring solution offered):
   a. number of previous restructurings.

4. Exposure balance:
   a. high value
   b. low value
   c. multiple exposures.

5. Level of risk (based on credit institution's assessment/behaviour scoring/internal behaviour data/transaction history/credit rating). Clients with better payment histories are more likely to respond positively to restructuring offers:
   a. very high
   b. high
   c. medium
   d. low.

6. Based on borrower's behaviour:
   a. seasonal repayments
   b. cooperative versus non-cooperative.
7. Purpose of credit facility (by product):

a. principal private residence loan
b. secondary home/holiday home loan
c. investment property loan/buy-to-let loan
d. personal loan
e. overdraft account
f. leased asset
g. credit card
h. sole trader, micro-enterprise or SME loan:
    i. for the set-up of the business (premises; infrastructure or machinery; renovations)
    ii. working capital.

8. Loan currency.

9. Loan interest rate (interest rate reduction consideration for loans burdened by high interest rates, if possible).

10. Borrower outlook (borrower's age, health, employment type and history, employment prospects, professional skills, industry).

11. Country of residence/incorporation:
    a. residents
    b. non-residents.

12. Location of the underlying collateral:
    a. rural versus urban
    b. prime location, city centre, outskirts, etc.

13. Type of underlying collateral:
    a. land:
        i. building plot
        ii. agricultural land
    b. building:
        i. house
        ii. shop

iii. factory.

14. Based on the loan-to-value (LTV) ratio:
    a. for low LTV loans, sale of underlying collateral may be the preferred option, unlike for high LTV loans.

15. Hardship cases (e.g. health problems, separation, divorce).

16. Borrower's creditworthiness assessment:
    a. can afford loan repayment versus cannot afford it;
    b. income less expenditure versus reasonable living expenses versus loan instalment.

Annex 2 – Benchmarks for NPE monitoring metrics

Benchmarks for NPE monitoring metrics

NPE metrics

NPE level and flows	NPE stock / total volume of exposures
	NPE stock + foreclosed assets + performing forborne/total volume of exposures + foreclosed assets
	Quarterly flow of NPEs (+/-) / total NPE stock
	Quarterly flow from performing exposure (PE) to NPE
	Quarterly flow from performing FBE to NPE
	Quarterly flow from NPE to PE
	Quarterly flow from NPE to performing FBE
	Quarterly flow from performing FBE to PE
	Quarterly flow from PE to performing FBE
Impairments	Quarterly increase in stock of loss allowances
	Quarterly level of reversal of impairments
	Quarterly change in stock of loss allowances(+/-) / total NPE stock
	Accumulated total provisions/total NPE stock
	By cohort (e.g. number of years since NPE classification, secured/unsecured)
Loss budget	Total loss as a result of forbearance activity
	Total loss versus budget

Collection activities

Staff activity	Number of borrower engagements per quarter versus plan Number of borrower engagements leading to forbearance agreement Number of borrower engagements leading to cash recovery Quarterly cash recovery from NPEs/total NPE stock Quarterly cash recovery from interest on NPEs/total NPE stock

Cash recovery	Quarterly cash recovery from capital and fees on NPEs/total NPE stock Quarterly cash recovery from property-related liquidations, also as a percentage of total NPE stock Quarterly cash recovery from non-property-related liquidations, also as a percentage of total NPE stock Quarterly cash recovery from sales of NPEs, also as a percentage of total NPE stock Quarterly cash recovery from NPEs, also as a percentage of total NPE stock

Forbearance activities	
Debt forgiveness	Quarterly debt forgiveness Quarterly debt forgiveness/specific assigned provisions Quarterly debt forgiveness/total NPE stock
Accounting write-offs	Quarterly accounting write-offs (full and partial) Quarterly accounting write-offs (full and partial) / individually assessed stock of loss allowances Quarterly accounting write-offs (full and partial)/total NPE stock Value of NPEs currently in forbearance Value of recently agreed forbearance solutions by characteristics (e.g. payment holiday > 12 months)

	Value of loans currently in forbearance / total NPE stock
Forbearance activity	Value of PEs currently in forbearance
	Quarterly non-performing FBEs / total NPE stock
	Total non-performing FBEs / total NPE stock
	Value of non-performing FBEs currently experiencing financial difficulties
	Cure rate
	Cash collection rate
Re-default rate	Re-default rate on non-performing FBEs
	Re-default rate on performing FBEs
Debt/asset swap	Quarterly debt to equity swaps, also as a percentage of total NPE stock
	Quarterly debt to asset swaps, also as a percentage of total NPE stock

Legal activities	Value and number of loans currently in legal activity
	Value and number of assets recently foreclosed
	Quarterly value and number of loans newly entering legal activity
	Quarterly value and number of loans exiting legal activity
	Average duration of legal procedures recently closed
	Average amounts recovered from legal procedures recently closed (including total costs)
	Loss rate on loans exiting legal activity

Profits and loss (P&L) items stemming from NPEs	
	Interest payments recognised on NPEs in the P&L

Interest from NPEs	Percentage of recognised interest payments from NPEs actually received

Annex 3 – Other monitoring metrics

Borrower-level information from external sources	
External sources	Debt and collateral increase in other credit institutions Past due or other non-performing classifications in other credit institutions Guarantor default Debt in private central register (if any) Legal proceedings Bankruptcy Changes in company structure (e.g. merger, capital reduction) External rating assigned and trend therein Other negative information regarding major borrowers/counterparties of the borrower/suppliers

Borrower-level information from internal sources	
Corporates	Negative trend in internal rating Unpaid cheques Significant change in liquidity profile Liabilities (leverage) (e.g. equity/total < 5% or < 10%) Number of days past due Number of months with any overdraft/overdraft exceeded Profit before taxes/revenue (e.g. ratio < –1%) Continued losses Continued excess in commercial paper discount

	Negative own funds
	Payment delays
	Decrease in turnover
	Reduction in credit lines related to trade receivables (e.g. year-on-year variation, 3 million average/1 year average)
	Unexpected reduction in undrawn credit lines (e.g. undrawn amount/ total credit line)
Individuals	Negative trend in behavioural scoring
	Negative trend in PD and/or internal rating
	Mortgage loan instalment > *x* credit balance
	Mortgage and consumer credit days past due
	Decrease in the credit balance > 95% in the last 6 months
	Average total credit balance < 0.05% of total debt balance
	Forborne
	Related historic loss rates
	Decrease in payroll in the past 3 months
	Unemployment
	Early arrears (e.g. 5–30 days past due, depending on portfolio/borrower types)
	Reduction in bank transfers in current accounts
	Increase in loan instalment over the payroll ratio
	Number of months with any overdraft exceeded

	Negative trend in behavioural scoring
	Negative trend in PD and/or internal rating

Portfolio-level information	
Portfolio distribution	Size distribution and concentration level
	Top *x* (e.g. 10) groups of connected clients and related risk indicators
	Asset class distribution
Risk parameters	Breakdown by industry, sector, collateral type, country, maturity, etc.
	PD/LGD evolution (overall and per portfolio)
	PD/LGD forecasts and projections
	Overall expected losses
Stock of loss allowances	Default exposure
	Stocks and flows of loss allowances (overall and per portfolio)
	Volumes of and trends in significant risk provisions at individual level
NPE/forbearance status/foreclosure	NPE volume by category (> 90 days past due, loss allowances, etc.)
	Forbearance volume and grouping of exposures (restructuring, workout, forced prolongation, other modifications, deferrals, > 90days past due, loan loss provisions)
	Foreclosed assets on total exposures

	NPE ratio without foreclosed assets
	NPE ratio with foreclosed assets
	NPE coverage (loss allowances, collateral, other guarantees)
Specific type of borrower/sector	
Legal activities	Value and number of loans currently in legal activity
	Value and number of assets recently foreclosed
	Quarterly value and number of loans newly entering legal activity
	Quarterly value and number of loans exiting legal activity
	Average duration of legal procedures recently closed
	Average amounts recovered from legal procedures recently closed (including total costs)
	Loss rate on loans exiting legal activity

Annex 4 – Common NPE-related policies

Credit institutions shall develop, regularly review and monitor their adherence to policies related to the NPE management framework.

Credit institutions shall establish the following policies, taking into account the principle of proportionality, aiming to achieve the implementation of the strategy of the credit institution (including its NPL strategy and operational plan where relevant).

Arrears management policy

This policy shall set out the credit institution's NPE operating model (see section 4.2.2), including at least the following elements:

- the structure and responsibilities of the NPE WUs, with clear handover triggers and a link to the grouping of exposures (see Section 4.2.2.3);
- the procedure to be followed by the functions involved, to include at a minimum:
    - the procedure and handover criteria to be followed for each stage of arrears, early arrears and late arrears;
    - the procedure to be followed where a borrower is classified as non-cooperating and/or non-viable, and the criteria for the borrower to be classified as such;
    - the communication with the borrower at each step, which should be aligned with the legislative framework of the country of operation (e.g. code of conduct);
    - monitoring tools and methods to be applied;
- the human and technical resource requirements;
- the reports to be produced internally for monitoring purposes and for regular updates to the board of directors.

Credit institutions, when developing their arrears management policy, shall take into account regulation 17C of the Credit Agreements for Consumers Relating to

Residential Property Regulations (S.L. 378. 10) and in particular the provisions of the EBA Guidelines on arrears and foreclosure (EBA/GL/2015/12).

Forbearance policy

The forbearance policy described in Section 4.3.3.1 shall, at least, set out:

- The necessary financial and non-financial documentation to be requested and provided by the different types of borrowers in order for the responsible credit officer to demonstrate repayment capacity on a principal and interest basis.

- The minimum key financial repayment capacity metrics and ratios to be applied by the credit officer, detailed on a portfolio-/product-/sector-specific basis, in order to fully assess the borrower's repayment capacity; sector-specific guidelines for establishing key financial metrics and ratios on a sector-specific basis (SMEs and corporates).

- The process for determining and implementing the most appropriate forbearance solution for a borrower:

    - For retail customers, decision trees are to be used. The process for retail customers should be in line with the provisions of the EBA Guidelines on arrears and foreclosure (EBA/GL/2015/12). For non-retail borrowers, if a decision tree approach is not appropriate, then the policy shall provide clear instructions to the credit officer on how to assess the suitability of a forbearance treatment.

    - In the case of borrowers for whom no solution can be reached (non-viable and/or non-cooperating borrowers), a time-bound process and procedure shall be established for the transfer of these borrowers to the NPE WUs responsible for liquidation.

- A toolkit of forbearance measures with short-term and long-term time horizons, as outlined in Section 4.3.

- Clear instructions to the credit officer regarding the requirements for revaluation of collateral in line with Section 4.6.

- The decision-making process, approval levels and procedures for each type of forbearance measure and size of exposure.

- The process and procedure for the monitoring of the forbearance solutions granted and borrower performance following the completion of a restructuring, including frequency of the review of the borrower, the re-default definition, the process for reassessment and requirements for reporting of re-defaults.

- The pricing policy for each forbearance measure and type of borrower.

Debt recovery/enforcement policy

The NPE WUs responsible for debt recovery shall take the most appropriate actions in a timely manner to effectively reduce NPEs over a defined time horizon. The debt recovery policy, in accordance with the NPL strategy, shall address, at a minimum:

- The range of available options for each collateral type. Indicatively, the following could be considered (not in any particular order):

    - voluntary asset sale (borrower re-engages and agrees to sell the asset);
    - forced asset sale via receivers/court proceedings (assets are not held on the balance sheet of the credit institution);
    - foreclosure of asset (assets are held on the balance sheet of the credit institution);
    - debt collection (internal or external);
    - debt to asset/equity swap;
    - sale of loan/loan portfolio to a third party.

- The procedure to be followed to select the most appropriate recovery option and the team of internal and external experts to be involved in taking the decision.

- The recovery option should take into account the existence of collateral, type of legal documentation, type of borrower, local market conditions and

macroeconomic outlook, the legislative framework in place, and potential historical recovery rates for each option versus the costs involved for each option.

- A clear definition of non-cooperating borrowers or a link to related policies including such a definition.

- A clearly defined approval process for each stage of the debt recovery process for the different recovery options available to the credit institution.

- The role of risk control and internal audit departments in the procedure and in the monitoring process.

With respect to the liquidation of collateral, credit institutions shall, in their policy, define the following :

- The valuation approach to be followed in respect of the asset (in line with Section 4.7) including the liquidation costs to be applied.

- Involvement of internal or external experts.

- Limits

    - to the amount of assets that can be held by the credit institution at any point of time, taking into account the large exposure limits specified in the CRD and industry concentration risk;

    - to the amount of repossessed or foreclosed assets that can be acquired by the credit institution within a certain time period.

- The procedure to be followed post repossession or foreclosure to develop and implement a sale strategy, and the unit within the credit institution responsible for undertaking the management of the assets concerned (this may also be defined in a separate foreclosed/repossessed asset policy).

Credit institutions shall consider the interaction with other creditors for NPE borrowers with multiple creditors, usually corporate borrowers. Therefore, credit institutions shall put in place a clear procedure for negotiating and interacting with other financial institutions (or other third parties) to whom the borrower is indebted.

Collateral policies

Given the importance of credit risk mitigation in the NPE workout process, credit institutions shall develop clear and consistent collateral policies, including policies for foreclosed assets. These policies shall comprehensively cover the management, valuation and reporting of all collateral types. Given the complexity and specialisation of some types of collateral, credit institutions shall seek external expertise in drafting and reviewing these policies. Credit institutions shall ensure a consistent approach to managing and valuing similar collateral across the portfolio, as per section 4.6.

NPE monitoring policy

Credit institutions shall establish a dedicated policy specifying, inter alia:

- the types of actions required in response to the different types of findings;
- escalation procedures;
- key elements, frequency and recipients of the reporting;
- handover criteria/a link to NPL procedures.

Outsourcing/NPL servicing policy

Credit institutions shall establish a dedicated policy for the outsourcing of services to third parties if this is relevant. This needs to include the required procedures for the selection of outsourcing partners, the required legal contract content and the decision-making process for outsourcing agreements, as well as the monitoring of those agreements.

Annex 5 – Possible forbearance measures

Forbearance measure	Description	Viability and other important considerations
1. Interest only	During a defined short-term pe only interest is paid on credit fac and no principal repayment is m The principal amount thus rer unchanged and the terms fo repayment structure are reasse at the end of the interest-only pe subject to the assessed repay ability.	This measure should be considered viable only if the credit institution can demonstrate (based on reasonable documented financial information) that the financial difficulties experienced by the borrower are of a temporary nature and that after the defined interest-only period the borrower will be able to service the loan at least to the extent of the previous repayment ability. The measure should generally not exceed a period of 24 months and, in the case of construction of commercial property and project finance, 12 months. Once the defined period of this forbearance measure is over, institutions should reassess the borrower's debtservicing capacity in order to proceed with a revised repayment schedule that is able to account for the unpaid capital element during this interest-only period. In most cases, this measure will be offered in combination with other measures of a longer-term nature to compensate for the temporary lower repayments (e.g. extension of maturity).
2. Reduced payments	Decrease in the amount of repayment instalments over a defined short-term period in order to accommodate the borrower's affected cash flow situation, before continuing with the repayments on the basis of projected repayment ability. The interest remains to be paid in full.	See '1. Interest only'. If the amount of the payment reduction is moderate and all other conditions mentioned above are met, this measure could be applied for a period longer than 24 months.

3. Grace period/payment moratorium	An agreement allowing the borrower a defined delay in fulfilling the repayment obligations, usually with regard to the principal and interest.	See '1. Interest only.'
4. Arrears/interest capitalisation	Forbearance of arrears and/or accrued interest arrears by the addition of those unpaid amounts to the outstanding principal balance for repayment under a sustainable rescheduled programme.	The measure should be granted/considered viable only where the institution has assessed that the borrower's verified income/expenditure levels (based on reasonable documented financial information) and the proposed revised repayments are sufficient to enable the borrower to service the revised loan repayment on a principal and interest basis for the duration of the revised repayment schedule, and where the institution has formally sought confirmation that the borrower understands and accepts the capitalisation conditions. Arrears capitalisation should be provided only selectively in cases where the recovery of historical arrears or payments due under the contract is not possible and capitalisation is the only option realistically available. Institutions should generally avoid offering this measure to a borrower more than once, and the measure should be applied only to arrears that do not exceed a predefined size relative to the overall principal (which should be defined in the credit institution's forbearance policy). The institution should assess the percentage of arrears being capitalised compared with the principal and interest repayments as adequate and appropriate for the borrower.

5. Interest rate reduction	Permanent (or temporary) reduction in interest rate (fixed or variable) to a fair and sustainable rate.	Exposures with high interest rates are one of the common causes of financial distress. The financial difficulties of a borrower may partly derive from the fact that the interest rates are excessively high compared with the income of the borrower or from the fact that the evolution of interest rates, as opposed to a fixed rate, has resulted in the borrower receiving finance at an exorbitant cost, compared with prevailing market conditions. In such cases, an interest rate reduction could be considered.
		If affordability can be achieved only at below-risk or below- cost rates, this should be clearly flagged. This measure could be applied also as a short-term measure.
6. Extension of maturity/term	Extension of the maturity of the loan (i.e. of the last contractual loan instalment date), which allows a reduction in instalment amounts by spreading the repayments over a longer period.	If the borrower is subject to a compulsory retirement age, term extension should be considered viable only where the institution has assessed and can demonstrate that the borrower can, through a pension or other sources of verified income, service the revised loan repayments on an affordable basis. Term extension should be considered viable only where it is in line with the life cycle of existing collaterals or proper substitution of the existing collaterals occurs.
7. Additional collateral	Additional liens on unencumbered assets are obtained as additional collateral from the borrower in order to compensate for the higher risk exposure and as part of the restructuring process.	This measure is not a viable standalone forbearance measure as it does not in itself resolve the presence of arrears on a loan. It usually aims to improve or cure LTV ratio covenants. Additional collateral may take many forms, such as a pledge on a cash deposit, assignment of receivables or a new/additional mortgage on immovable property. Institutions should value second and third liens on assets as well as personal guarantees with care.

8. Sale by agreement/assisted sale	The credit institution and the borrower agree to voluntarily dispose of the secured asset(s) to partially or fully repay the debt.	Credit institutions should restructure any residual debt post the assisted sale with an appropriate repayment schedule in line with the borrower’s reassessed repayment ability. For forbearance measures that may require the sale of the property at the end of the term, credit institutions should conservatively consider the future approach to any shortfall that could remain after the sale of the property and address it as early as possible. For exposures that are repaid by repossession of collateral at a predefined moment, the repossession does not constitute a forbearance measure unless it is exercised ahead of the predefined moment due to financial difficulties.
9. Rescheduled payments	The existing contractual repayment schedule is adjusted to a new sustainable repayment programme based on a credible, current and forecasted assessment of the borrower’s cash flow	Different repayment options may include: **i.** Partial repayment: when a payment is made against the exposure, for example from a sale of assets that is lower than the outstanding balance. This option is applied to significantly reduce the exposure at risk and to enable a sustainable repayment programme for the remaining outstanding amount. This option should be preferred to the bullet and step-up options described below. **ii.** Balloon or bullet payments: when the rescheduled repayment ensures a large payment of the principal at a later date before loan maturity. This option should be used/considered viable only in exceptional circumstances and when the institution can duly demonstrate future cash flow availability by the borrower to meet the balloon or bullet payment. **iii.** Step-up payments: credit institutions should consider a solution including this option viable

		only when they can ensure, and are able to demonstrate, that there is good reason to expect that future increases in payments can be met by the borrower.

10. Conversion of currency	When the currency of exposure is aligned with currency of the cash flow.	theCredit institutions should explain thefully to borrowers the risks of foreign exchange and should also refer to currency conversion insurance.
11. Other alteration of contract conditions/covenants	When the credit institution discharges the borrower of covenants or conditions included in a loan agreement not listed above.	
12. Refinancing/new credit facilities	Providing new financing arrangements in order to support the recovery of a distressed borrower.	This is usually not a viable standalone forbearance measure; it should be combined with other forbearance measures addressing existing arrears. It should be applied only in exceptional cases.

		New credit facilities may be granted that may entail the pledging of additional collateral. In the case of inter-creditor arrangements, the introduction of covenants may be necessary to compensate for the additional risk incurred by the credit institution. This measure may be more suitable for corporate exposures; a thorough assessment of the borrower's ability to pay should be performed, including sufficient involvement of independent sectoral experts to judge the viability of business plans and cash flow projections provided. This measure should be considered viable only when the thorough affordability assessment demonstrates repayment capacity in full.
13. Debt consolidation	Combining multiple exposures into a single exposure or a limited number of exposures.	This is usually not a viable standalone forbearance measure; it should be combined with other forbearance measures addressing existing arrears. This measure is particularly beneficial in situations where combining collateral and secured cash flow provides greater overall collateral coverage for the entire debt, for example, by minimising cash leaks or by facilitating reallocation of cash flow surplus between exposures.

14. Partial or total debt forgiveness	The credit institution forfeits the right to legally recover part or the whole of the amount of the debt outstanding from the borrower.	This measure should be used where the credit institution agrees to a 'reduced payment in full and final settlement' whereby the credit institution will forgive all of the remaining debt if the borrower repays the reduced amount of the principal balance within an agreed timeframe. Credit institutions should apply debt forgiveness options carefully, since the possibility of forgiveness can give rise to moral hazard and thus might encourage 'strategic defaults'. Therefore, institutions should define specific forgiveness policies and procedures to ensure strong controls are in place.

Annex 6 – Connected Clients Under Article 4(1)(39) of Regulation (EU) No 575/2013

INTRODUCTION

1. This Annex focuses on the treatment of connected clients as defined in Article 4(1)(39) of the CRR and clarifies and operationalises the concept of interconnection, in particular when control issues or economic dependency should lead to the grouping of clients because they constitute a single risk in accordance with Article 4(1)(39) of the CRR.

SCOPE AND APPLICATION

2. This Annex applies to all credit institutions that are licensed under the Act and is implementing the European Banking Authority (EBA) Guidelines on connected clients under Article 4(1)(39) of Regulation (EU) No 575/2013 ('the Guidelines'), issued on 14 November 2017.

3. The scope of this Annex is to specify the approach which credit institutions, as defined under Article 2 of the Act, shall take in applying the requirement to group two or more clients into a 'group of connected clients' because they constitute a single risk in accordance with Article 4(1)(39) of the CRR. Credit institutions shall refer to the Annex of the EBA Guidelines for the illustration of scenarios related to the application of the provisions of this Annex.

4. Two types of interconnection are considered in the definition of connected clients in Article 4(1)(39) of the CRR:
   i. clients that are directly or indirectly interconnected by a control relationship as defined in Article 4(1)(37) of the same Regulation; and
   ii. clients that are interconnected by some form of economic dependency as set out in Article 4(1)(39)(b), inter alia:
      - direct economic dependencies such as supply chain links or dependence on large customers; or
      - a common main source of funding in the form of credit support, potential funding or direct, indirect or reciprocal financial assistance.

5. This Annex applies to all areas of the CRR where the concept of connected clients is used, i.e. the large exposures regime (Part Four of the CRR), the categorisation of clients in the retail exposure class for the purposes of credit risk (Article 123(c) and

Article 147(5)(a)(ii)), the development and application of rating systems (Article 172(1)(d)) and the SME supporting factor (Article 501(1)(c)).

GROUPS OF CONNECTED CLIENTS BASED ON CONTROL

6. In applying Article 4(1)(39) of the CRR, credit institutions shall assume that two or more clients constitute a single risk when there is a control relationship between them.
7. In exceptional cases, where credit institutions are able to demonstrate that no single risk exists despite the existence of a control relationship among clients, credit institutions shall document the relevant circumstances that justify this case in a detailed and comprehensible manner.

8. Credit institutions shall apply the concept of control as defined in Article 4(1)(37) of the CRR as follows:
   a. In relation to clients that prepare their consolidated financial statements in conformity with the Companies Act 1996, credit institutions shall rely on the control relationship between a parent undertaking and its subsidiaries within the meaning of Article 13(1) and 13A(1)-(3) of the Act. For this purpose, credit institutions shall group clients accordingly on the basis of their clients' consolidated financial statements.
   b. In relation to clients that prepare their consolidated financial statements in conformity with the international accounting standards adopted by the Commission in accordance with Regulation (EC) No 1606/2002, credit institutions shall rely on the control relationship between a parent undertaking and its subsidiaries within the meaning of those accounting standards. For this purpose, credit institutions shall group clients accordingly on the basis of their clients' consolidated financial statements.
   c. In relation to clients to which point (a) or point (b) of this paragraph do not apply (e.g. natural persons, central governments, and clients that prepare consolidated financial statements in accordance with the accounting rules of a third country), credit institutions shall deem relationships between any natural or legal person and an undertaking that are similar to the parent undertaking/subsidiary relationships mentioned in points (a) and (b) of this paragraph to be control relationships.

   When conducting this assessment, credit institutions shall deem any of the following criteria to constitute a control relationship:

i. holding the majority of the shareholders' or members' voting rights in another entity;
ii. right or ability to appoint or remove a majority of the members of the administrative, management or supervisory body of another entity;
iii. right or ability to exercise a dominant influence over another entity pursuant to a contract, or provisions in memoranda or articles of association.

Other possible indicators of control that credit institutions shall consider in their assessment include the following:

i. power to decide on the strategy or direct the activities of an entity;
ii. power to decide on crucial transactions, such as the transfer of profit or loss;
iii. right or ability to coordinate the management of an entity with that of other entities in pursuit of a common objective (e.g. where the same natural persons are involved in the management or board of two or more entities);
iv. holding more than 50% of the shares of capital of another entity.

9. Given that the decisive factor for the assessment of the existence of a control relationship is the accounting criteria or indicators of control set out in paragraph 8(a), (b) and (c), credit institutions shall group two or more clients on account of a relationship of control even where these clients are not included in the same consolidated financial statements as a result of exemptions applied to them under the relevant accounting rules.

10. Credit institutions shall group two or more clients into a group of connected clients on account of a relationship of control among these clients regardless of whether or not the exposures to these clients are exempted from the application of the large exposures limit under Article 400(1) and (2) of the CRR or in accordance with exemptions under Regulation 6(2) of S.L. 371.17 on the CRR (Implementing and Transitional Provisions) Regulations.

ALTERNATIVE APPROACH FOR EXPOSURES TO CENTRAL GOVERNMENTS

11. In line with the definition of 'group of connected clients', credit institutions may assess the existence of a group of connected clients separately for each of the persons directly controlled by or directly interconnected with the central government ('alternative approach').

12. Article 4(1)(39) of the CRR allows for a partial application of the alternative approach, assessing separately the natural or legal persons directly controlled by or directly interconnected with the central government.

13. The same provision of the CRR also makes clear that:
    a. The central government is included in each of the groups of connected clients identified separately for the natural or legal persons directly controlled by or directly interconnected with the central government.
    b. Each group of connected clients under point (a) includes also persons controlled by or interconnected with the person who is directly controlled by or directly interconnected with the central government.

14. Where entities are directly controlled by or directly interconnected with the central government and are economically dependent on each other, they should form separate groups of connected clients (excluding the central government), in addition to the groups of connected clients formed in accordance with the alternative approach.

15. By virtue of the last sentence of the last subparagraph of Article 4(1)(39) of the CRR, paragraphs 11 to 14 are also applicable to regional governments or local authorities to which Article 115(2) of the CRR applies, and natural or legal persons directly controlled by or interconnected with these regional governments or local authorities.

ESTABLISHING INTERCONNECTEDNESS BASED ON ECONOMIC DEPENDENCY

16. When assessing interconnectedness among their clients based on economic dependency, in accordance with Article 4(1)(39)(b) of the CRR, credit institutions shall take into account the specific circumstances of each case, in particular whether the financial difficulties or the failure of a client would lead to funding or repayment difficulties for another client.

17. In the event that an institution is able to demonstrate that the financial difficulties or the failure of a client would not lead to funding or repayment difficulties for another client, these clients need not be considered as a single risk. In addition, two clients need not be considered a single risk if a client is economically dependent on another

client in a limited way, in that the client can easily find a replacement for the other client.

18. An institution shall consider, in particular, the following situations when assessing economic dependency:
    a. Where a client has fully or partly guaranteed the exposure of another client and the exposure is so significant for the guarantor that the guarantor is likely to experience financial problems if a claim occurs. (This situation refers to guarantees that do not comply with the eligibility requirements provided for in Part Three, Title II, Chapter IV (Credit Risk Mitigation) of Regulation (EU) No 575/2013 and, consequently, in relation to which the substitution approach (referred to in Article 403 of that Regulation) cannot be used for prudential purposes).
    b. Where a client is liable in accordance with his or her legal status as a member in an entity, and the exposure is so significant for the client that the client is likely to experience financial problems if a claim against the entity occurs.
    c. Where a significant part of a client's gross receipts or gross expenditures, on an annual basis, is derived from transactions with another client (e.g. the owner of a residential/commercial property the tenant of which pays a significant part of the rent) that cannot be easily replaced.
    d. Where a significant part of a client's production/output is sold to another client of the institution, and the production/output cannot be easily sold to other customers.
    e. Where the expected source of funds to repay the loans of two or more clients is the same and none of the clients has another independent source of income from which the loan may be serviced and fully repaid.
    f. Other situations where clients are legally or contractually jointly liable for obligations to the institution (e.g. a debtor and his or her co-borrower, or a debtor and his or her spouse/partner).
    g. Where a significant part of the receivables or liabilities of a client is to another client.
    h. Where clients have common owners, shareholders or managers. For example, horizontal groups where an undertaking is related to one or more other undertakings because they all have the same shareholder structure without a single controlling shareholder or because they are managed on a unified basis. This management may be pursuant to a contract concluded between the undertakings, or to provisions in the memoranda or articles of association of those undertakings, or if the administrative management or supervisory bodies of the

undertaking and of one or more other undertakings consist for the major part of the same persons.

19. Credit institutions shall consider the non-exhaustive list of situations in paragraph 18 when assessing connections among shadow banking entities. Credit institutions shall give due consideration to the fact that relationships between entities falling under the definition of shadow banking entities will most likely not consist of equity ties but rather of situations of de facto control or relationships characterised by contractual obligations, implicit support or potential reputational risk (e.g. sponsorship or even branding).

20. If an institution's client is economically dependent on more than one client, which are not dependent on each other, the institution shall include the latter clients in separate groups of connected clients (together with the dependent client).

21. Credit institutions shall form a group of connected clients where two or more of their clients are economically dependent on an entity, even if this entity is not a client of the institution.

22. Credit institutions shall group two or more clients into a group of connected clients on account of economic dependency among these clients regardless of whether or not the exposures to these clients are exempted from the application of the large exposures limit under Article 400(1) and (2) of the CRR or in accordance with exemptions under Regulation 6(2) of the CRR (Implementing and Transitional Provisions) Regulations.

ECONOMIC DEPENDENCY THROUGH A MAIN SOURCE OF FUNDING

23. Credit institutions shall consider situations where the funding problems of one client are likely to spread to another on account of a one-way or two-way dependency on the same funding source. This does not include cases where clients get funding from the same market or where clients' dependency on their existing source of funding is caused by the clients' deteriorating creditworthiness, such that they cannot easily replace that source of funding.

24. Credit institutions shall consider cases where the common source of funding depended on is provided by the credit institution itself, its financial group or its connected parties Being clients of the same credit institution does not in itself create

a requirement to group the clients if the credit institution providing funding can be easily replaced.

25. Credit institutions shall also assess any contagion or idiosyncratic risk that could emerge from the following situations:
    a. use of one funding entity (e.g. the same bank or conduit that cannot be easily replaced);
    b. use of similar structures;
    c. reliance on commitments from one source (e.g. guarantees, credit support in structured transactions or non-committed liquidity facilities), taking into account its solvency, especially where there are maturity mismatches between the maturity of underlying assets and the frequency of the refinancing needs.

RELATION BETWEEN INTERCONNECTEDNESS THROUGH CONTROL AND INTERCONNECTEDNESS THROUGH ECONOMIC DEPENDENCY

26. Credit institutions shall first identify which clients are connected via control in accordance with Article 4(1)(39)(a) of the CRR ('control group') and which clients are connected via economic dependency in accordance with Article 4(1)(39)(b) of the same Regulation. Subsequently, credit institutions shall assess whether the identified groups of connected clients need to be (partially) connected themselves.

27. In their assessment, credit institutions shall consider each case separately, identifying any possible contagion ('domino effect') based on the individual circumstances.

28. Where clients that are part of different control groups are interconnected via economic dependency, all entities for which a chain of contagion exists need to be grouped into one group of connected clients. Downstream contagion shall always be assumed when a client is economically dependent and is itself the head of a control group. Upstream contagion of clients that control an economically dependent entity should be assumed only when this controlling client is also economically dependent on the entity that constitutes the economic link between the two controlling groups.

CONTROL AND MANAGEMENT PROCEDURES FOR IDENTIFYING CONNECTED CLIENTS

29. Credit institutions shall have a thorough knowledge of their clients and their clients' relationships. Credit institutions shall also ensure that their staff understand and apply this Annex.

30. Identification of possible connections among clients shall be an integral part of a credit institution's credit granting and surveillance process. The Board of Directors and senior management shall ensure that adequate processes for the identification of connections among clients are documented and implemented.

31. Credit institutions shall identify all control relationships among their clients and document as appropriate. Credit institutions shall also investigate, and document as appropriate, any potential economic dependencies among their clients. Credit institutions shall take reasonable steps and use readily available information to identify these connections. If, for example, a credit institution becomes aware that clients have been considered interconnected by another credit institution it shall take into account that information.

32. The efforts that credit institutions put into the investigation of economic dependencies among their clients shall be proportionate to the size of the exposures. Therefore, credit institutions shall strengthen their investigations, by extensive research of any type of 'soft information' as well as information that goes beyond the credit institutions' clients, in all cases where the sum of all exposures to one individual client exceeds 5% of Tier 1 capital.

33. To assess grouping requirements based on a combination of control and economic dependency relationships, credit institutions shall collect information on all entities forming a chain of contagion. Credit institutions might not be able to identify all clients that constitute a single risk if there are interconnections that stem from entities that are not in a business relationship with the credit institution and are therefore unknown to the credit institution. However, if a credit institution becomes aware of interconnections via entities outside its clientele, it should use this information when assessing connections.

34. Control and management procedures for identifying connected clients shall be subject to a periodic review to ensure their appropriateness. Credit institutions shall also monitor changes to interconnections, at least in the context of their periodic loan reviews and when a substantial increase to a loan is planned.