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Project	**Financial Instruments: Impairment**		
Paper topic	Definition of default		
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Purpose of this paper

1. At the July 2013 joint board meeting, the staff provided a high level summary of the main messages received during the outreach activities and comment period on the Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* ('the ED').

2. Although the vast majority of participants and respondents supported the proposals in the ED, constituents have identified certain areas/topics where the ED proposals should be improved and/or clarified. One such area was the notion of default and more particularly, what would constitute default in the context of the proposals.

3. In particular respondents to the comment letters and some participants in the field work and outreach activities noted that default should be clearly defined in order to promote consistency as it is fundamental to the measurement of the probability of a default occurring. Respondents in particular highlighted the measurement of the 12-month expected credit losses ('ECL') and the assessment of significant deterioration to be dependent on how default is defined.

4. Both the 12-month ECL (Stage 1) and the lifetime ECL (Stages 2 and 3) are measured based on the probability of a default occurring. Financial instruments are classified as Stage 1 when credit risk has not increased significantly since initial recognition.

5. The assessment of whether credit risk has increased significantly is determined by comparing the probability of a default occurring at the reporting date with the probability at initial recognition.

6. The ED did not propose a definition of default or provide any application guidance on what constitutes a default event or how it should be interpreted. This is because the IASB did not expect that expected credit losses would change as a result of differences in the definition of default because of the counterbalancing interaction between the way an entity defines default and the credit losses that arise given that definition of default[1]. In accordance with paragraph BC97 of the ED, entities are therefore able to apply their own definitions of default including, where applicable, regulatory definitions of default.

7. The purpose of this paper is to consider the views expressed during the outreach activities and comment period and to discuss the following approaches identified from the feedback received:

   (a) **Approach 1**: Define default as payment default only (paragraphs 34 – 43);

   (b) **Approach 2**: Define default by including qualitative factors (paragraphs 44 – 53);

   (c) **Approach 3**: Define a rebuttable presumption to act as a backstop (paragraphs 54 – 60);

   (d) **Approach 4**: Do not define default (similar to ED) (paragraphs 61 – 67).

[1] Said differently, if a broader definition of "loss event" is used, the "loss realised as a result of the loss event" (ie, the severity) is smaller.

8. The staff's preferred approach is **Approach 3** as this allows entities to apply the definition used for internal credit risk management purposes, but provides a backstop of 180 days past due that will improve the consistency of application.

Structure of this paper

9. This paper is set out as follows:

   (a) Detailed feedback received (paragraphs 10 – 16);

   (b) How default is defined in practice (paragraphs 17 – 20);

   (c) Importance of default in the context of a the model proposed in the ED (paragraphs 21 – 31);

   (d) Analysis of alternatives suggested (paragraphs 32 – 67); and

   (e) Staff recommendation and questions to the IASB (paragraphs 68 – 71).

Detailed feedback received

10. Although the ED did not include a specific question on default, some respondents specifically commented on this. It has also been raised by some participants during outreach events and as part of the field work. The majority of these respondents recommended that default should be clearly described or defined. These respondents disagreed with the IASB's presumption in paragraph BC97 that expected credit losses would not change depending on the definition of default because of the counterbalancing interaction between the definition of default and the credit losses that arise given that definition. They noted that the notion of default is fundamental to the application of the proposed model; in particular, to the measurement of 12-month expected credit losses (ECL) and the assessment of significant deterioration (see paragraphs 21 – 31 for a detailed discussion).

11. Furthermore, some respondents considered the term ‘default event’ to be ambiguous and considered it not clear whether the notion of default is intended to align more closely with the indicators about when there has been a significant increase in credit risk (Stage 2) or with objective evidence of impairment (Stage 3).

12. Some respondents were concerned that in the absence of more prescriptive guidance about what the IASB intended, differences in interpretation could lead to inconsistent application in different periods and a lack of comparability between entities.

13. Regulators in particular were concerned that default may be interpreted solely as non-payment (payment default) instead of capturing indicators of loss expectations that accelerate eventual non-payment. They were concerned that relying on payment default alone to determine the changes in the probability of a default occurring would result in the delayed recognition of lifetime expected credit losses, especially for financial instruments where non-payment is expected towards maturity when principal amounts become contractually due.

14. Some seemed to be concerned that focussing on payment default would result in no change in loss allowance balances until payment defaults actually occur. While (as set out below) using payment defaults or a broader definition would have an effect on allowance balances, the staff notes that the model focuses on a change in the probability or likelihood of a default occurring. So allowance balances should change to reflect changes in the likelihood of [payment] defaults occurring not just to reflect whether [payment] defaults have actually occurred.

15. However, some respondents noted that the point of default will be different for different products and across jurisdictions. These respondents welcomed that default has not been specifically defined but recommended that additional guidance is provided on what would constitute a default event within the context of the proposals.

16. A few of the respondents that specifically commented on default agreed with the IASB's presumption in paragraph BC97 and noted that there is generally a common understanding about what constitutes default, any attempt to be more prescriptive or provide guidance will add confusion and may result in a difference in default definition for credit risk management and accounting purposes. They recommended the IASB retain paragraph BC97 and make it clearer that entities should apply their own definition of default.

How default is defined and applied in practice

17. The term default is a key element of managing credit risk and is generally used to refer to any instance in which an obligor fails to comply with the contractual conditions of an obligation. The term default can be interpreted in various ways and it is important to understand the difference between the various types of default. For example:

    (a) **Payment default** – this is a relatively narrow interpretation of default and refers to the failure to make a contractual payment of principal and/or interest on time (or the failure to make payment within x number of days of the due date). This includes administrative/accidental defaults where a customer accidentally fails to make a payment on time, for example the customer went on holiday and makes the payment upon his return.

    (b) **Technical default** – this is a broader interpretation and arises not just from the failure to make a contractual payment on time but from the failure to uphold some other aspect of the contractual terms, for example breach of financial covenants or failure to submit audited financial statements within a specified period after the reporting date.

18. While the definitions of default applied in practice vary from entity to entity, the following observations can be made:

    (a) Rating agencies apply a fairly narrow definition which focusses mainly on payment default and other related indicators such as bankruptcy and

distressed restructurings. Technical defaults are usually excluded from their definitions.

(b) Regulators, such as Basel, apply a broader definition which in addition to non-payment also considers an obligor's ability (likeliness) to pay future contractual payments in full. This can include among other indicators, technical defaults.

19. On one end of the spectrum, there is therefore a judgemental definition that considers qualitative factors and on the other end a non-judgemental definition that only focusses on non-payment. In practice, the definition of default applied by entities depends on the information they have available. For example, if an entity does not have updated borrower-specific information that could indicate an obligor's ability to satisfy future contractual payments, the entity will only focus on non-payment. However, if an entity has access to borrower-specific information (ie bureau data, cross-defaults), it will be able to assess an obligor's ability to satisfy future contractual obligations before the obligor misses a payment.

20. The definition of default applied could also depend on the nature of the financial instruments. For retail lending products (ie credit cards, unsecured personal lending, mortgages), the contractual terms do not typically include qualitative default clauses (such as technical defaults) and an entity may only define default based on the days past due. In contrast, for some financial institutions payment default is less relevant for certain products/exposures (such as corporate lending products) where the contractual terms include a number of technical default events designed to be triggered prior to a payment default occurring. In these situations default is mainly defined based on a combination of technical defaults and usually considers the point at which an entity ceases trying to impose or re-impose the contractual conditions, and instead focuses on contract(ual) termination, renegotiation or other remedy. For example, if an obligor breaches a certain number of technical default clauses, the obligor is considered to be in default even if no contractual payments have yet been missed.

Importance of default in the context of the proposed deterioration model

Assessment of significant increase in credit risk

21. Paragraph 8 of the ED requires that changes in the probability of a default occurring should be used to determine whether there has been a significant increase in credit risk since initial recognition. To make this assessment, an entity should compare the probability of a default occurring at the reporting date with the probability of a default occurring at initial recognition of the financial instrument[2].

22. The definition of default is therefore the parameter against which the probability of that event occurring is calibrated. In other words, if default is defined as 90 days past due ('dpd'), a significant increase in credit risk is determined by reference to the probability of a financial instrument becoming 90 dpd. An entity's assessment of significant deterioration could therefore be different depending on the definition of default applied (for example the assessment for the same financial instruments could differ if a 90 dpd defection is used or a 180 dpd definition is used).

23. The assessment of significant deterioration is also impacted by whether a narrow or broad definition of default is applied. A broad definition that incorporates qualitative factors will consider an obligor to be in default earlier than one only based on non-payment. For example, the probability that an obligor will breach a number of technical default clauses over the life of an instrument could be much higher than the probability of payment default (eg 90 dpd) occurring over its life. Changes in those probabilities of a default occurring for a broad definition will therefore also be different from changes in the probabilities of non-payment occurring. Because the assessment of significant deterioration is based on the change in that probability since initial recognition, it may affect the population of financial instruments for which lifetime ECL are recognised.

[2] The key principle is that the risk of default be considered rather than that a specific probability of default be determined. This will be addressed in at a future meeting. 'Default' risk is however still the focus.

Measurement of 12-month ECL

24. Appendix A of the ED defines 12-month ECL as:

> The expected credit losses that result from those default events on the financial instruments that are possible within the 12 months after the reporting date.

25. For the purpose of measuring 12-month ECL the definition of default is important as the measurement needs to reflect the probability of that default event occurring in the 12 months after the reporting date. While it is true that an earlier definition of default (eg 30 dpd rather than 90 dpd) would normally be associated with a reduction in the severity of the loss, the effect of the interplay between the definition of default and the recognition of lifetime ECL is not completely eliminated by this off-setting effect. Differences in how default is defined will therefore drive variations in the measurement of the loss allowances because of the different population of financial instruments captured inside and outside of Stage 1.

26. Considering the same example as in paragraph 22 above, a broad definition of default results in instruments to be considered in default earlier than a narrow definition. The probability that an instrument may default within the 12 months after the reporting date, will therefore also be higher. For example, if an entity uses a statistical (PD) approach to measure expected credit losses, the higher lifetime PD will result in a higher 12-month PD, which in turn, will result in a higher 12-month allowance when compared to a narrow definition.

27. Similarly, if an entity uses delinquency to define default, a definition of default of 90 dpd or 180 dpd can have a material impact on the number of loans that could be expected to default within the 12 months after the reporting date. More instruments would have a probability of becoming 90 dpd than would be 180 dpd or 360 dpd. The more narrowly default is defined, the later it is identified, and the lower the probability will be that an instrument will be in default.

28. Respondents therefore considered it important to ensure a common understanding of what constitutes default in the context of the proposed model to prevent diversity in the interpretation and application of the model.

Interaction with objective evidence of impairment

29. Some respondents have noted that the definition of default is important to define the population of financial assets for which interest revenue should be recognised on the net carrying amount (ie Stage 3 assets). They have questioned the interaction between the definition of default and the indicators for objective evidence of impairment.

30. They have noted that a current reading of the ED indicates that financial assets in Stage 3 include those that have defaulted, but will also include other financial assets, for example, those for which an active market has disappeared. These respondents recommended that Stage 3 be defined as financial assets that have defaulted.

31. The staff note that the interaction between default and objective evidence of impairment, as well as the population of financial assets for which interest revenue recognition should be different, will be discussed at a future meeting and will not form part of this agenda paper.

Analysis of alternatives identified

32. The following approaches were identified from the feedback received on the notion of default:

    (a) **Approach 1**: Define default as payment default only;

    (b) **Approach 2**: Define default by including qualitative factors;

    (c) **Approach 3**: Define a rebuttable presumption to act as a backstop;

    (d) **Approach 4**: Do not define default (similar to ED).

33. The IASB could also consider a combination of the above approaches, ie Approach 2 combined with Approach 3, or Approach 1 combined with Approach 2.

Approach 1: Define default as payment default only (quantitative)

34. As discussed in paragraph 10 above, most of the respondents that commented specifically on default, recommended that default should be clearly defined. However, respondents were split about whether it should be defined on a 'principle' basis or as a specified number of days past due. Most of the respondents that supported defining a specific number of days, recommended that such a definition should be consistent with the quantitative element of the definition used for regulatory purposes (ie 90 days past due), as this will enable them to leverage the models and systems used for regulatory reporting. These respondents consider this element of the regulatory definition to be well understood and applied consistently.

Advantages

35. One of the main advantages of having an explicit definition of default, ie 90 dpd, is that it ensures a consistent application of default and would increase comparability between entities. This is because the probability that an instrument will go into default will be calibrated consistently for all entities.

36. A further advantage is that a consistent definition of default will ensure that a consistent population of instruments that could go into default within the 12 months after the reporting date is considered for the measurement of 12-month ECL.

37. Users of financial statements expressed concern about an apparent lack of comparability between similar entities because of differences in definitions and assumptions. During outreach meetings, users have recommended that default be defined explicitly to ensure consistency and comparability. This approach will eliminate the differences in how default is defined and address some of the users' concerns.

Disadvantages

38. In developing the proposals in the ED and addressing concerns about operability, one of the IASB's objectives was to allow entities to leverage existing credit risk management systems and models as much as possible. A definition that only focusses on payment default may not be consistent with the default definition applied internally for credit risk management purposes or even externally for regulatory reporting purposes.

39. As noted by some respondents, default for credit risk management purposes may be defined in different ways for different instrument types. For example, as stated in paragraph 20 above, for some entities payment default is not relevant for some financial instruments such as corporate lending instruments where an obligor may be in default before any payments are missed. For these instruments, qualitative factors are also considered.

40. Defining a specified number of days past due as default may also not capture what risk managers consider to be a default. This is because although some entities apply payment default only, the number of days past due that is considered to constitute a default may differ among various types of instruments. For example, default on an unsecured personal loan may be regarded as 90 dpd whereas for a mortgage it may be 180 dpd.

Staff analysis

41. Even with a clearly defined quantitative element to the default definition, the Basel Committee on Banking Supervision noted in a recent report on risk weighted assets that the quantitative element is not necessarily applied in a consistent way. This is because of the discretion exercised by some jurisdictions in the application of the quantitative element[3]. The report noted the following:

[3] See *Regulatory Consistency Assessment Programme (RCAP) Analysis of risk-weighted assets for credit risk in the banking book* , section 5.1.2, published in July 2013. Available externally at: http://www.bis.org/publ/bcbs2

.pdf

> 5.1.2 Definition of default
>
> The regulatory framework incorporates discretionary elements into the definition of default for some asset classes. Differences in the definition of default affect all estimated risk parameters, […]
>
> For retail obligors and public sector entities, explicit discretion is granted for supervisors to choose to extend the past due period in the default definition from 90 up to 180 days, and about half of the jurisdictions exercise discretion in this regard. […].
>
> Another significant difference is whether days past due is defined on a "time" basis, eg a borrower is in default when 90 days have passed since the borrower was up to date, or a "money" basis, when amounts overdue are equivalent to 90 days' payments.

42. The staff believe that defining default as a specified number of days past due would be arbitrary. There is no set number that will work in all circumstances and for all instruments. Furthermore, even defining default on a principle basis as payment default only, will for many entities not be consistent with their internal definitions and will require a separate set of risk parameters to be maintained for accounting purposes only.

43. The costs involved in recalibrating existing measures of probabilities of a default event occurring may far outweigh the benefits of having consistency and comparability particularly in the context of the measurement of expected credit losses which is inherently subjective. Furthermore, the usefulness and relevance of expected credit loss information to users of financial statements will be diminished if it is merely an accounting construct and not representative of how an entity manages credit risk internally. The staff therefore do not recommend this Approach.

Approach 2: Define default by including qualitative factors

44. For many of the reasons set out in paragraphs 38-40, some respondents recommended that the IASB define default in a broad sense that consider qualitative factors as well.

45. As explained in paragraphs 17-20 above, a broader interpretation of default considers qualitative indicators about a customer's ability to meet future contractual obligations in addition to payment default. These qualitative indicators can include technical defaults as described in paragraph 17(b) and usually considers the point at which an entity ceases trying to impose or re-impose the contractual conditions, and instead focuses on contractual termination, renegotiation or other remedy.

46. There could also be some interaction between the definition of default and the indicators of objective evidence of impairment for the purposes of recognising interest revenue on financial assets in Stage 3 (as noted in paragraphs 29-31 above) but this will be discussed at a future meeting.

Advantages

47. The advantage of defining default in a qualitative manner is that it will allow those entities that apply similar qualitative definitions for regulatory purposes to leverage those systems and models without requiring significant changes. This will mitigate the cost of implementation and the need to maintain a separate set of risk parameters for accounting purposes only.

Disadvantages

48. Being able to apply a qualitative definition of default is dependent on the availability of the necessary information. As noted in paragraphs 19-20 above, most entities typically manage instruments such as retail products on a portfolio basis and do not have access to updated borrower-specific information necessary to make an assessment about terminating an individual position prior to payment default occurring.

49. It is also questionable whether a qualitative definition of default will address the concerns raised about consistent application as entities' interpretations of qualitative factors may differ. There may also be jurisdictional differences in the timing of when an entity may take such action which will hamper consistency and comparability.

50. The other disadvantages of this approach are similar to those listed for Approach A. The broader definition of default may not be consistent with an entity's internal credit risk management practices in certain circumstances giving rise to recalibration issues and information about expected credit losses will therefore not being useful and relevant to the users of the financial statements.

Staff analysis

51. Although the staff consider this approach to be conceptually superior to Approach 1 and consistent with how the IASB intended default to be applied, we are concerned about the implications for entities that do not have access to the necessary information and that apply a narrow default definition for credit risk management purposes.

52. Furthermore, the ED proposed that entities use information that is currently used for credit risk management purposes and that is available without undue cost or effort.

53. In light of this, the staff do not think entities can be required to apply a definition of default for accounting purposes that is broader than that currently used for credit risk management purposes. The staff therefore do not recommend this approach.

Approach 3: Rebuttable presumption of 180 days to act as a backstop

54. The objective of Approach 3 is to allow entities to apply their internal credit risk management definition of default but with a rebuttable presumption that financial assets are considered to have defaulted no later than when they are 180 dpd. If an entity has other more timely measures (eg 90 dpd or other qualitative indicators) of default relevant to a portfolio they could use that. In other words, 180 dpd would be seen as the latest point at which a financial asset could be considered to be in default, unless an entity has reasonable and supportable information to support more lagging default criteria.

Advantages

55. The rebuttable presumption of 180 dpd will allow entities to apply default in a way that is consistent with their internal credit risk management systems, however narrowly or broadly that is defined. However, the 180 dpd quantitative limit will serve as 'backstop' to ensure a more consistent population of financial instruments are considered when measuring the 12-month ECL and in assessing significant deterioration. The purpose of the rebuttable presumption is not to delay default until 180 dpd but instead to ensure that entities will not define default as later than 180 dpd without reasonable and supportable information to substantiate the assertion. Furthermore, jurisdictions where default can legally only be considered to have occurred after contractual payments become x number of years (eg 5 years) past due would estimate expected credit losses on a basis that is more consistent with other jurisdictions.

Disadvantages

56. Similar to defining the specific number of days past due for the purposes of Approach 1, defining it for the purpose of the rebuttable presumption will be arbitrary. As mentioned under Approach 1, even regulatory definitions are not uniform and contain discretionary elements. There is no conceptual basis to determine the number of days past due that would be appropriate for all financial asset types and across all jurisdictions. This is alleviated somewhat in that the 180 days is a backstop.

Staff analysis

57. The staff acknowledge that allowing entities to apply the definition used for credit risk management purposes with a backstop of 180 dpd could result in an outcome that is similar to combining the advantages of Approach 1 and Approach 2 while minimising their disadvantages. This would also result in an outcome that is similar to the definition applied by some regulators where default is defined as payment default (eg 90 days) and on the basis of qualitative indicators.

58. Most respondents to the comment letters and participants in the outreach and fieldwork indicated that where default is defined by reference to non-payment, it is usually based on 90 dpd. These entities would therefore be able to rebut the presumption on the grounds that their credit risk management systems reflect default earlier and more responsively than 180 dpd.

59. However, the staff note that respondents to the comment letters have raised some concerns about the conceptual basis for the proposed rebuttable presumption that credit risk has increased significantly when an instrument is more than 30 dpd. These respondents consider rebuttable presumptions to introduce apparent bright lines to a principles-based model. Some interested parties are also concerned that regulators, auditors and users of financial statements will expect the rebuttable presumption to be applied consistently by all entities and that an entity that has rebutted it will be penalised for having done so.

60. This approach could address most of the concerns raised by those respondents that requested a definition of default to be included in the proposed model. It also provides at least some discipline around this important concept.

Approach 4: Do not define default

61. Approach 4 is similar to the ED in that default is neither defined nor is guidance provided on how it should be interpreted. BC97 already makes it clear that entities should apply their own definition of default without placing any limitations or restrictions.

Advantages

62. This approach is consistent with the proposals in the ED that allow entities to use information that is currently used for credit risk management purposes and that is available without undue cost or effort. Information will be the most relevant and useful if it faithfully reflects how an entity manages credit risk. It also enables entities to select a measure that best reflects default given the financial instruments in question.

63. As some respondents have noted, flexibility is key to the definition of default because it is inherently industry, product and jurisdiction specific and any attempt to be more prescriptive may contradict that, which will result in misleading information being reported.

Disadvantages:

64. The disadvantages of this approach are reflected in the concerns raised by respondents that requested a definition be provided. Because of the differences in credit risk management practices and regulations, default may be applied in a number of ways which will lead to a lack of comparability among entities.

65. For the reasons set out in paragraphs 24-28 above, inconsistent definitions of default will lead to differences in the expected credit losses represented by the 12-month ECL.

Staff analysis

66. The staff acknowledge the concerns raised by constituents about the lack of consistency and comparability in the absence of a default definition, and the importance of this definition to the application of the model proposed in the ED.

67. The staff think that some of the concerns raised could be addressed by explaining in the application guidance that default has not been defined because it is not possible to define default in a way that will be consistent with credit risk management and appropriate for all entities in all circumstances. Furthermore, entities could be required to apply the definition of default used for credit risk management purposes and disclose how it has been applied.[4] Credit risk managers could then use a definition of default that is relevant and meaningful for the instrument in question (ie that appropriately reflects the real economic default). This should result in the use of information that provides decision useful information about credit quality.

[4] Paragraph 39 of the ED already requires disclosure of how an entity has defined default.

Staff recommendation and questions to the Board

68. The staff have **rejected** Approach 1 and Approach 2 on the grounds that one of the objectives of the proposed model was to consider and allow the use of information that is used for credit risk management purposes. Both these approaches would define default in a way which may not be consistent with the internal definition applied by an entity, that may not capture the credit quality of products in a meaningful way, and that therefore result in information that is not relevant or useful to the users of financial statements.

69. The staff consider **Approach 3** to be the most appropriate and **preferred** approach as it allows a default definition to be applied that is consistent with internal credit risk management practices but provides a backstop of 180 days. This will result in the most relevant and useful information for users of financial statements and improve consistency of application.

70. Approach 4 has many of the advantages of Approach 3, but is not the staff's preferred approach because it is too open ended given how important the default concept is in the proposed model. However, should the IASB not wish to set an arbitrary backstop, the staff would recommend Approach 4 as it addresses most of the concerns raised.

71. In the staff's view, irrespective of the alternative selected, disclosure of the definition of default applied should be required as proposed in the ED.

Questions to the IASB

1. Does the IASB agree with the recommendation for a rebuttable presumption to act as a backstop (Approach 3), as set out in paragraph 69?

2. If the IASB does not agree with the staff recommendation, which approach does the IASB prefer?

3. If the IASB prefer Approach 1 or Approach 2, how should default be defined?