



A simple guide to the new European default rules

This document was prepared during the Inter-Associative Sharing Table on International Regulatory Initiatives (CIRI) formed in implementation of the 2019 Credit Agreement with a view to bringing the new rules on default to the attention of businesses in order to facilitate their relationship with banks and other financial intermediaries

The new European default rules

The new European rules on the classification of debtors in "default" (i.e., in a state of default on an obligation to the bank) establish criteria and methods that are more stringent than those adopted to date by Italian financial intermediaries.

Under the current provisions, companies that have significant payment arrears for more than 90 consecutive days on their exposures to banks are automatically classified as in default.

The new rules specify that significant arrears are defined as amounts in excess of EUR 500 (relating to one or more loans) representing more than 1%¹ of the company's total exposure to the bank. For natural persons and small and medium-sized enterprises with exposures to the same bank totalling less than EUR 1 million, the amount of EUR 500 is reduced to EUR 100.

Unlike in the past, the company will no longer be able to use the margins still available on its credit lines to offset outstanding defaults and avoid classification in default.

Generally speaking, the classification of a company in a state of default, even in relation to a single loan, means that all its exposures to the bank go into default. In addition, it could have negative repercussions on other companies economically linked to it that are exposed to the same financial intermediary.

It is therefore essential for companies to be aware of the new rules and to comply with contractual payment deadlines, so as not to fall behind in repaying their debts to banks, even for small amounts. This is to prevent the bank from being required to classify the company in default and initiate actions to protect its claims, as required by European supervisory regulations.

¹ With the Act issuing the 3rd update of 23 December 2020 of Circular No. 288 of 3 April 2015, the Bank of Italy established that for financial intermediaries not belonging to banking groups or not included in the scope of consolidated supervision pursuant to the CRR, and for financial groups the relative component of the materiality threshold for credit exposures in arrears is set at 5% until 31 December 2021, without prejudice to the application as of 1 January 2021 of the remaining provisions on default.

16 FAQs about default

1. What are the new European and domestic provisions on default?

European Union Regulation no. 575 of 26 June 2013² on prudential requirements for credit institutions (the *Capital Requirements Regulation* – CRR) introduces specific provisions in art. 178 on debtor default, providing a mandate to the European Banking Authority (EBA) to issue guidelines on the application of the definition of default and to the European Commission to adopt a Delegated Regulation on the measurement of the materiality threshold of exposures in arrears on the basis of the regulatory technical standards published by the EBA.

On 28 September 2016, the EBA published both the guidelines on the definition of default³ and the technical standards on the "materiality threshold" (for the definition of materiality threshold see Question 3).

On this basis, the European Commission with Delegated Regulation (EU) No. 171 of 19 October 2017⁴ then specified the criteria for setting the materiality threshold, which supervisory authorities are required to follow.

Based on this guidance, the Bank of Italy issued a Communication dated 26 June 2019⁵, in which it provided information on the modifications introduced to the definitions of impaired credit exposures applied in supervisory statistical reporting and the financial statements of banks, which take into account the provisions of the above-mentioned Commission Delegated Regulation (EU) No. 171/2018 and the EBA Guidelines on the definition of default.

More recently, the National Supervisory Authority, in a note dated 15 October 2020⁶, provided further application-related clarifications.

2. By when will banks have to adopt the new definition of default?

Banks subject to direct supervision by the European Central Bank (i.e. those with European significance) will have to notify the latter before 1 June 2019 of the exact date starting from which they will begin to apply the materiality threshold on exposures in arrears, defined by the new European rules.

² The text of the Regulation is available on the European Union website at the following link:

<https://eur-lex.europa.eu/legal-content/IT/TXT/PDF/?uri=CELEX:32013R0575&from=IT>

³ The guidelines are available for consultation on the EBA's website at the following link

https://eba.europa.eu/documents/10180/1721448/Guidelines+on+default+definition+%28EBA-GL-2016-07%29_IT.pdf/bd010dde-c308-4057-ae9c-842c2462a7ec

⁴ The text of the delegated regulation can be found on the European Union website at the following link <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R0171&from=LV>

⁵ The communication is available on the Bank of Italy's website at the following link

https://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/circolari/c272/Com_26giugno2019.pdf

⁶ The note is available on the Bank of Italy's website at the following link:

https://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/circolari/c285/risposte_quesiti_applicativi/Nota-di-clarification-2020.10.15.pdf?pk_campaign=EmailAlertBdi&pk_kwd=en

In any case, the deadline by which the bank is required to implement the new rules is 1 January 2021⁷.

3. How is the materiality threshold for exposures in arrears defined?

Under the new rules, a bank is required to classify an exposure in default when the company is more than 90 days in arrears on a material credit obligation. In order to determine the materiality of the exposure, a materiality threshold has been identified, divided into two components: i) an absolute component equal to EUR 500 and ii) a relative component equal to 1%⁸ of the total amount of the company's exposures to the lending bank.

Exceeding the materiality threshold, as discussed below (see question 12), should be assessed at the level of the banking group, thus taking into account all of the company's exposures⁹ to banks and financial intermediaries in the same group.

An exposure is classified as in default when it exceeds the materiality threshold as regards both the absolute and relative components for a period of more than 90 days.

For natural persons and small and medium-sized enterprises with a total exposure to the bank of less than EUR 1 million, the absolute component of the materiality threshold is reduced to EUR 100.

4. Should a company that is more than 90 days in arrears for an amount below the materiality threshold be classified in default?

If there is no other assessment of the likelihood that the company will meet its obligations, the company does not necessarily need to be classified in default. For automatic classification in default, the amount in arrears must be material, according to what is set forth in the European regulations, for more than 90 consecutive days.

5. If a single exposure defaults, will all of the company's outstanding exposures to the same bank automatically default?

Yes, according to the general rule.

However, in the case of SMEs with a total exposure to the bank of less than EUR 1 million, default on a single exposure does not necessarily lead to an automatic default on all of the company's other exposures to the same financial intermediary. For these types of companies, the bank may in fact decide to apply the definition of default at individual credit line level.

In this case, default on an individual exposure would not automatically extend to all of the company's other exposures to the same bank, unless the arrears on that

⁷ Also in accordance with the provisions of the Bank of Italy's Communication of 10 June 2020 on the start date of the application of the new default rules for smaller banks.

This document is available at the following link:

https://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/circolari/c285/Comunicazione-10-giugno-2020.pdf?pk_campaign=EmailAlertBdi&pk_kwd=en

⁸ See footnote 1.

⁹ Exposures related to cash advances or payment delegations present in the bank's financial statements are also included in the calculation of materiality thresholds.

exposure represents a significant portion of the debtor's total exposures to the same bank.

6. How are the days of arrears calculated?

Days in arrears are calculated from the day after the date on which the amounts due for principal, interest and fees have not been paid and have exceeded the materiality thresholds set forth by the new rules.

If the payments defined in the original loan agreement have been suspended and the due dates have been modified, subject to a specific agreement formalised with the bank, the calculation of days in arrears follows the new repayment schedule.

7. Is it possible to offset overdue amounts against other credit lines not used by the same debtor?

The European Banking Authority has expressly ruled out this possibility.

Therefore, unlike in the past, the bank will be required to classify the company in default even if it has credit lines still available with the same bank that could be used to offset outstanding defaults and avoid default.

8. To what extent may the default of one company have consequences for another company related to it?

According to the new rules, banks should survey the connections between their customers, so as to identify cases in which the default of a company may have a negative impact on the ability to repay of another, related debtor (“contagion effect”), with the consequence that the latter may also be considered in default¹⁰.

The connection between different companies may result from links of control or of an economic nature (e.g. companies belonging to the same supply chain).

9. For exposures taken out by two or more debtors, jointly and severally liable for repayment (“joint obligations”), what happens if one of the debtors defaults?

For joint credit obligations related to SMEs with a total exposure to the bank of less than EUR 1 million, the default of just one debtor does not automatically extend to joint obligations.

If all jointly exposed debtors are classified as in default, the joint obligation is also automatically considered in default; likewise, if the joint obligation is classified as in default, the obligations of all individual debtors are also considered in default.

In the case of partnerships, any default of the company results in the default of the unlimited liability partners as well.

10. In the event of delayed collection of payment due to system malfunction (“technical situations of arrears”), should the bank still consider the company in default?

Technical situations of arrears, due to the malfunctioning of the payment system or errors in the bank’s processes that result in the delayed or incorrect crediting of the payment made, do not lead to the default of the company.

11. In addition to the arrears criterion, in what other situations may a debtor be declared in default?

Even if the company has not had any material arrears for more than 90 days, it may be classified as in default if, on the basis of the information in its possession, the bank considers it unlikely that it will be able to recover its credit without enforcing any guarantees it has acquired or, for unsecured positions, when the bank considers that the company is no longer able to correctly meet its obligations.

¹⁰ For further details please refer to paragraph 61 of the EBA Guidelines on the application of the definition of default available at the following link https://eba.europa.eu/documents/10180/1721448/Guidelines+on+default+definition+%28EBA-GL-2016-07%29_IT.pdf/bd010dde-c308-4057-ae9c-842c2462a7ec

12. How does the definition of default apply if the creditor bank belongs to a group?

If a debtor is classified as in default by one bank, all other banks and financial intermediaries in the same group will also consider classifying it in a similar manner, even if that debtor does not have any exposures to them in arrears.

In addition, a bank that belongs to a group should assess whether the materiality threshold (see question 3) has been surpassed for more than 90 consecutive days for an exposure to which the definition of default applies at debtor level, not only with respect to the debtor's exposures to the bank, but also with respect to exposures to banks and intermediaries in the entire group.

13. After how long can the bank consider the company no longer in default?

Under the new rules, at least three months must elapse from when the conditions for classifying the company in default are no longer met in order to emerge from default status. During this period, the bank assesses the behaviour and financial situation of the company and, after three months, may reclassify the company in non-default status if it believes that the improvement in the company's credit quality is real and permanent.

14. What happens to exposures that are subject to forbearance measures?

Forbearance measures (i.e. changes to contractual terms and conditions as well as full or partial debt refinancing) may be granted by banks to companies that are experiencing, or are about to experience, difficulties in meeting their financial obligations to the bank.

However, the lending bank may have grounds to argue that the renegotiation of the client's debt is not a forbearance measure as the beneficiary company is not or is not about to be in difficulty in meeting its financial obligations to the bank. In this case, the bank will not report the exposure to the Supervisory Authority as in default due to it being subject to a forbearance measure. This may be the case for example with a loan suspension or extension carried out under the 2019 Credit Agreement in the event that the bank can argue that the company would not have had problems servicing the debt in any case.

For exposures to which forbearance measures have been applied, more stringent methods are applied for classifying the transaction in default. In particular, if the renegotiation of contractual terms results in a significant loss for the bank (i.e. debt forgiveness or payment deferral totalling more than 1%), the bank is forced to classify the exposure in default.

A company that, despite having received forbearance measures on its debt, is then nevertheless classified in default, will have to meet additional requirements in order to be removed from that status. In any event, at least one year must have elapsed since the measure was granted.

15. Can the Bank of Italy set different materiality thresholds for banks it supervises for the automatic classification of the exposure in default?

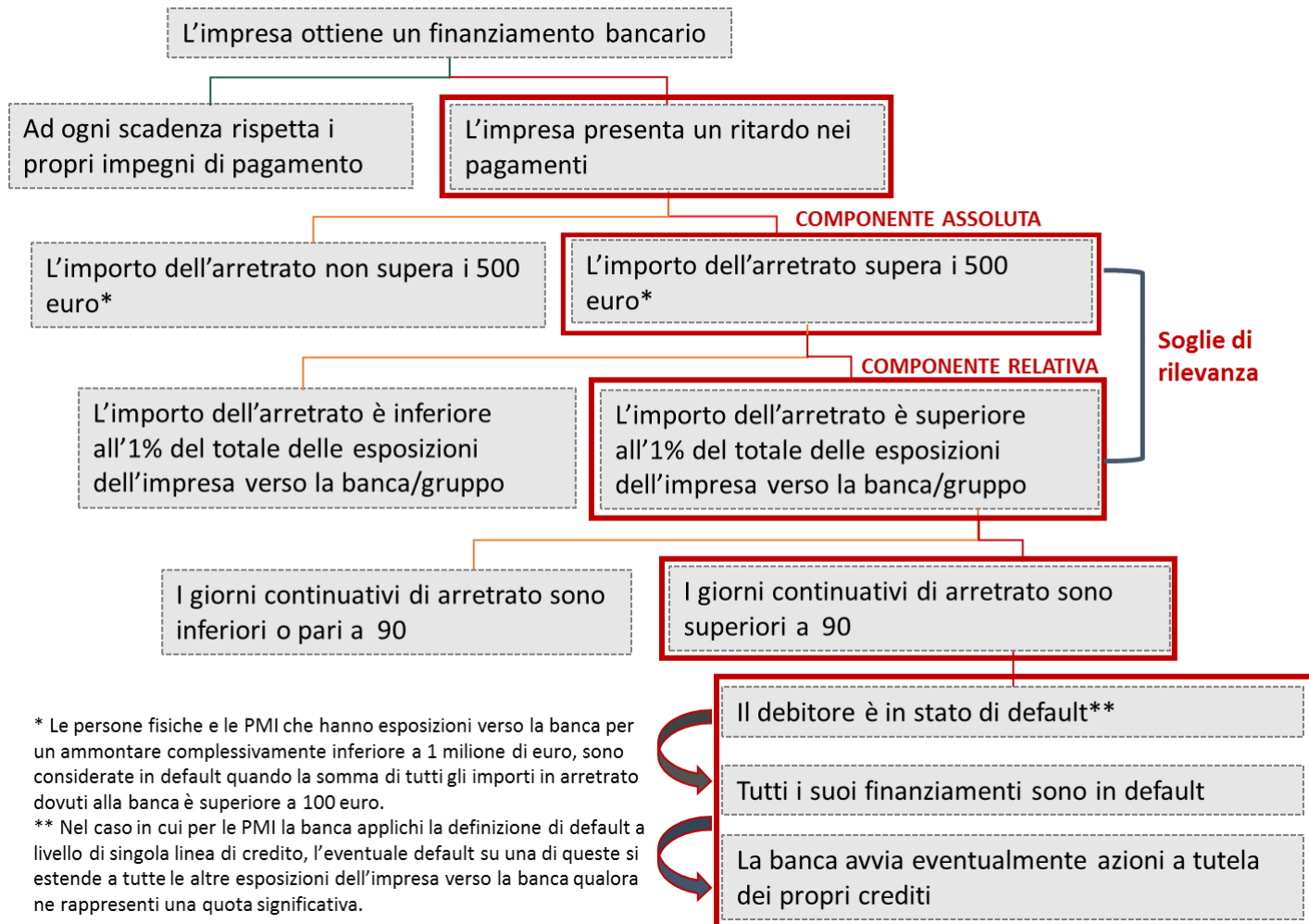
Yes, this is possible. The Bank of Italy carried out a public consultation to transpose the new European rules applicable to the banks it directly supervises (i.e., those that are not of European significance) into national law, which ended with the identification of similar materiality thresholds¹¹.

16. Do the new default rules apply only to banks or to other financial intermediaries as well?

The new default rules must be applied not only by banks, but also by all non-banking financial intermediaries that provide financing in any form (e.g. leasing companies).

¹¹ See footnote 1.

The decision tree - how to avoid default:



CLASSIFICATION OF THE COMPANY IN DEFAULT: WHAT CHANGES WITH THE NEW RULES

Main topics	Prior to New Definition of Default	After New Definition of Default
Definition of default	When at least one of the following conditions occurs: 1) The bank considers it unlikely that it will be able to recover the debt without enforcing guarantees. 2) The debtor is more than 90 days in arrears on a material exposure	Idem
Arrears materiality threshold	5% of the greater of the following values: - average of the past due or overdue amounts for the entire exposure recorded on a daily basis in the prior quarter; - past due or overdue portion of the entire exposure at the reporting date	The threshold is surpassed when the following conditions are jointly met: <ul style="list-style-type: none"> • Exposures to companies: <ul style="list-style-type: none"> - Absolute component=EUR 500; - Relative component = 1% of total exposure • Exposures to SMEs with exposures of less than EUR 1 mln: <ul style="list-style-type: none"> - Absolute component=EUR 100; - Relative component = 1% of total exposure
Offsetting between the debtor's different exposures to the bank	Permitted	Not permitted
Extension of the default of one exposure to all other exposures	The default on a single exposure leads to the automatic default of all of the company's outstanding exposures to the same bank. If the company qualifies as an SME and has a total exposure to the bank of less than EUR 1 million, the extension may not be automatic.	Idem
Contagion effect	At the bank's discretion	Banks should survey the economic and legal connections between their customers , so as to identify cases in which the default of a company may adversely affect the ability to repay of another related debtor.