Default recognition under Article 178 CRR: challenges and implications for standardised approach banks

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Abstract

Purpose – This concept paper aims to examine the operational, capital and governance challenges that European banks face when applying Article 178 of the Capital Requirements Regulation (CRR) to recognise default, with particular emphasis on Standardised Approach banks. While existing literature has largely focused on Internal Ratings-Based (IRB) institutions, the distinctive implications for banks using the Standardised Approach remain underexplored.

Design/methodology/approach – The analysis adopts a doctrinal and policy review methodology, drawing on primary regulatory texts, European Banking Authority guidelines, supervisory expectations and comparative practices from other jurisdictions. A stylised case illustration demonstrates how qualitative default recognition criteria affect capital adequacy and borrower relationships.

Findings – This paper highlights interpretive ambiguity, operational inconsistency and commercial conflicts inherent in invoking the "unlikely to pay" criterion. For Standardised Approach banks, default recognition can have disproportionately severe impacts on risk-weighted assets, IFRS 9 provisioning and competitive positioning. The comparative review indicates that while similar principles exist globally, supervisory approaches to proportionality and implementation vary.

Research limitations/implications – This study is conceptual and does not present empirical data or quantitative testing. The case examples are hypothetical and may require adaptation to specific institutional contexts or national regulatory frameworks.

Practical implications – This paper offers recommendations to strengthen governance, enhance transparency and improve proportionality in default recognition processes. It underscores the importance of codified criteria, independent oversight and clear borrower communication.

Social implications – Proportionate and transparent default recognition practices can protect borrowers, enhance trust in the banking system and promote financial stability. However, inconsistent application or excessive rigidity can harm credit access and borrower confidence.

Originality/value – By systematically analysing Article 178 through the lens of Standardised Approach banks, this paper addresses a gap in regulatory scholarship and provides actionable insights for practitioners and policymakers.

Keywords Article 178 CRR, Default recognition, Standardised Approach banks, Credit risk management, IFRS 9, Basel III, Banking regulation

Paper type Conceptual paper

1. Introduction

The timely and accurate recognition of default exposures is a foundational element of prudential regulation and risk management within the European banking sector. Article 178 of Regulation (EU) No 575 / 2013, commonly referred to as the Capital Requirements Regulation (CRR), provides the harmonised definition of default that governs all credit institutions across the European Union (European Union, 2013). This definition is critical

because it directly impacts capital requirements, credit risk measurement, financial reporting under IFRS 9 and broader supervisory expectations.

Article 178 establishes a dual framework for identifying default: the objective criterion of a material credit obligation being more than 90 days past due, and the subjective criterion of the institution considering that the obligor is unlikely to pay its obligations in full without recourse to actions such as the realisation of collateral. While the former is relatively clear and operationally straightforward, the latter—often referred to as the "unlikely to pay" criterion—relies on qualitative assessment and professional judgment (European Banking Authority, 2016). This reliance introduces interpretive ambiguity and operational complexity, particularly for banks applying the Standardised Approach, which lack the internal risk models and granular credit segmentation associated with Internal Ratings-Based (IRB) institutions.

Although regulatory guidance, including the European Banking Authority's (EBA) Guidelines on the Definition of Default and the European Central Bank's (ECB) supervisory statements, has sought to standardise practices (European Banking Authority, 2016; European Central Bank, 2017), the challenges of operationalising qualitative default indicators remain significant. These challenges are compounded by the close interdependence between prudential classification and financial reporting, where default under Article 178 often triggers Stage 3 impairment under IFRS 9, with substantial implications for provisioning and capital adequacy (International Accounting Standards Board, 2014).

While prior literature and supervisory publications have examined default recognition broadly, much of the focus has centred on IRB banks and model validation issues (Basel Committee on Banking Supervision, 2019). By contrast, the specific governance, proportionality and operational challenges faced by Standardised Approach banks have received comparatively limited attention.

This paper addresses this gap by systematically analysing the interpretation and implementation of Article 178 CRR in the context of Standardised Approach institutions. It explores the conceptual foundations of default recognition, assesses operational and capital implications and offers policy recommendations designed to improve consistency and proportionality. A comparative review of international regulatory frameworks and a stylised case illustration further enrich the analysis and underscore the practical significance of these issues.

1.1 Methodology

This study adopts a doctrinal and policy analysis methodology. It reviews primary EU legal texts, including the CRR and EBA Guidelines, as well as supervisory publications issued by the ECB and selected national authorities. To contextualise European practice, the paper also examines regulatory frameworks in other jurisdictions, such as the USA, Australia and Singapore. Finally, a stylised case scenario is used to illustrate the operational impact of invoking the "unlikely to pay" criterion in a Standardised Approach bank.

1.2 Literature review

Prior research on default recognition has primarily focused on Internal Ratings-Based (IRB) banks and the modelling of credit risk parameters. Early contributions by Resti and Sironi (2007) examined the calibration of probability of default and loss given default under Basel II, highlighting the complexities associated with internal model validation and back-testing. Subsequent studies have explored how regulatory definitions influence model outcomes and capital requirements (Fiori and Iannotti, 2007).

A significant body of literature has assessed the implementation challenges of IFRS 9 and its interaction with prudential regulation. Bischof and Daske (2016) observed that the forward-looking expected credit loss model has introduced substantial judgment and variability into provisioning practices. Novotny-Farkas (2016) further argued that IFRS 9's reliance on expected credit losses creates tension with prudential frameworks that historically emphasised incurred loss models.

More recent scholarship has examined the supervisory perspective on default recognition. The European Central Bank (2017) has underscored the importance of consistency and comparability, particularly following the Targeted Review of Internal Models (TRIM). Beck and Jakubik (2018) highlighted those divergent practices in default classification can undermine transparency and comparability of risk-weighted assets across institutions.

While this literature provides valuable insights into model risk and supervisory expectations, relatively little attention has been paid to the operational challenges faced by Standardised Approach banks. Most studies assume that such institutions rely primarily on objective arrears-based triggers, overlooking the practical necessity of applying qualitative criteria, including the "unlikely to pay" assessment. As a result, gaps remain in understanding how smaller institutions interpret and implement Article 178 CRR in practice and how governance and proportionality considerations shape these processes.

This paper seeks to address this gap by offering a targeted analysis of default recognition for Standardised Approach banks, incorporating regulatory context, operational challenges and international comparisons. By situating this discussion within the broader literature, the paper contributes to both scholarly and practitioner debates on prudential regulation and credit risk governance.

2. Regulatory background

The regulatory definition of default under Article 178 of the Capital Requirements Regulation (CRR) constitutes a cornerstone of the European prudential framework for credit institutions. This definition is designed to ensure consistency, transparency and comparability in how banks identify credit deterioration across the European Union (European Union, 2013).

2.1 Article 178 CRR – dual default criteria

Article 178 establishes two principal criteria for default classification:

(1) *Past-Due Criterion:* Default is deemed to occur when any material credit obligation is more than 90 days past due. For retail exposures secured by residential or SME commercial real estate, Member States may, under specified conditions, extend this threshold to 180 days.

(2) *Unlikely to Pay Criterion:* Default is also considered to have occurred if, in the institution's judgment, the obligor is unlikely to pay its credit obligations in full without recourse to actions such as the realisation of collateral.

This dual approach is intended to capture both objective arrears and forward-looking assessments of credit risk. The "unlikely to pay" criterion introduces a necessary degree of discretion but also creates interpretive challenges and potential inconsistency.

Article 178 further requires that if a default event arises in respect of any obligation of an obligor, all exposures to that obligor are to be classified as defaulted. For non-retail exposures, this contagion principle is mandatory, ensuring prudential conservatism and preventing selective recognition (European Union, 2013). In the case of retail exposures,

institutions have the option, as specified in Article 178(1)(b), either to apply obligor-level default classification or to assess default at the level of individual credit facilities, provided that the chosen approach is applied consistently over time (European Banking Authority, 2021).

2.2 EBA guidelines on the definition of default
To harmonise interpretation and implementation across Member States, the European Banking Authority (EBA) issued its *Guidelines on the Application of the Definition of Default* (EBA/GL/2016 / 07). These guidelines clarify key aspects of Article 178, including:

- Materiality Thresholds: Banks must establish thresholds combining absolute and relative components to ensure that minor technical arrears do not trigger default classification.
- Qualitative Indicators: Specific examples of "unlikely to pay" include significant financial difficulty, breach of contract or covenants, distressed restructuring and the initiation of bankruptcy or insolvency proceedings.
- Probation Periods: Exposures that return to performing status must remain cured for a defined probation period before exiting default status.
- Governance Expectations: Institutions are required to document criteria, monitor their consistent application and maintain appropriate oversight mechanisms.

These guidelines became applicable progressively from 2021, establishing a detailed framework that banks must integrate into internal policies and procedures.

2.3 IFRS 9 linkages
The prudential definition of default is closely linked to the accounting treatment of credit exposures under IFRS 9 *Financial Instruments*. Under IFRS 9, exposures meeting the definition of default are typically deemed "credit-impaired" and classified in *Stage 3*, necessitating the recognition of lifetime expected credit losses (International Accounting Standards Board, 2014). Although the EBA and the International Accounting Standards Board do not prescribe a one-to-one mapping, supervisory expectations emphasise consistency between default recognition for regulatory capital and for provisioning purposes (European Banking Authority, 2016). However, the forward-looking nature of IFRS 9 introduces complexities in aligning prudential and accounting standards, especially in the context of default recognition under Article 178 CRR (Kalista and Novotny-Farkas, 2025).

This linkage increases the operational impact of default classification decisions and reinforces the importance of robust governance.

2.4 Supervisory expectations and proportionality
While Article 178 CRR defines the framework for default recognition, the implementation is shaped by supervisory expectations, which may differ depending on whether the bank uses the Standardised Approach or the Internal Ratings-Based (IRB) Approach for credit risk. Under the IRB Approach, banks have greater autonomy in defining default triggers—especially qualitative indicators such as unlikeliness to pay—subject to validation by supervisory authorities. This allows for some flexibility, provided that internal models are robust, documented and regularly reviewed. However, for Standardised Approach banks, national regulators generally require strict adherence to the default indicators outlined in the CRR and the EBA Guidelines.

For instance, the European Banking Authority (EBA) has issued *Guidelines on the Application of the Definition of Default* (EBA/GL/2016 / 07), which aim to harmonise default classification across banks. These guidelines clarify that even when qualitative indicators (e.g., borrower unlikely to repay) are used, they must be applied consistently and conservatively. In practice, however, supervisory tolerance may vary across jurisdictions, creating room for interpretation—especially in the case of small deviations from the 90-day threshold, or in the use of temporary forbearance measures.

The EBA guidelines also allow for certain materiality thresholds, particularly for retail exposures, where default may not be triggered if the overdue amount is insignificant relative to the exposure or below a euro-denominated floor. Supervisors may permit exemptions for small-ticket delinquencies, provided they do not signal broader credit deterioration.

Overall, the combination of regulatory standards and supervisory flexibility requires banks to maintain a clear, well-documented policy for default recognition—one that aligns with both the letter and the spirit of the CRR while accounting for internal risk management capabilities.

The European Central Bank (ECB), in its capacity as the Single Supervisory Mechanism (SSM), has underscored the significance of accurate and timely default recognition (European Central Bank, 2017). Supervisory initiatives such as the *Supervisory Review and Evaluation Process* (SREP), which applies to all institutions regardless of whether they apply the Standardised Approach or IRB, have assessed the adequacy of policies, controls and monitoring. In addition, the *Targeted Review of Internal Models* (TRIM) focused specifically on the validation and consistent application of IRB models in credit risk measurement, including the correct implementation of default definitions within internal rating systems (European Central Bank, 2018).

While Article 178 applies uniformly to all credit institutions, proportionality remains a relevant supervisory principle. Smaller banks following the Standardised Approach may face greater challenges in developing granular frameworks, prompting supervisors to adopt proportionate expectations without compromising prudence or consistency (European Central Bank, 2018).

Collectively, these regulatory instruments and supervisory practices establish the foundation upon which banks are expected to interpret and operationalise default recognition in the European Union.

3. Invoking "unlikely to pay"—conceptual and practical challenges

While the 90-days-past-due criterion under Article 178 provides a clear and objective threshold for default recognition, the invocation of the "unlikely to pay" condition requires banks to make complex, judgment-based assessments. This reliance on qualitative evaluation introduces multiple challenges, particularly for Standardised Approach banks that lack the credit modelling sophistication of IRB institutions (European Banking Authority, 2016; European Central Bank, 2023).

3.1 Interpretive ambiguity

The first conceptual challenge concerns the inherent ambiguity of what constitutes "unlikely to pay." Article 178 does not prescribe an exhaustive list of triggers but rather sets out examples, leaving institutions to define the criteria operationally within their risk management frameworks (European Union, 2013). European Banking Authority (2016) enumerate indicators such as:

· Significant financial difficulty of the obligor.

- Breach of financial covenants.
- Initiation of bankruptcy or insolvency proceedings.
- Distressed restructuring involving concessions.

However, determining the point at which these events require default recognition is ultimately a matter of professional judgment. For example, a borrower's request for a short-term concession may reflect temporary liquidity stress rather than fundamental credit deterioration. Divergence in interpretation across institutions or business units' risks undermining consistency and comparability (European Banking Authority, 2018).

3.2 Timing and proportionality

The timing of default classification is particularly sensitive. Early recognition ensures prudence and aligns with supervisory expectations for prompt provisioning. However, premature classification can trigger negative consequences, including:

- Cross-default clauses in loan documentation.
- Reputational damage for the borrower.
- Loss of access to other credit facilities.

Delaying recognition, by contrast, can result in regulatory findings, under-provisioning and reputational harm to the bank itself (European Central Bank, 2017). For Standardised Approach banks without granular risk-rating systems, achieving proportionality while avoiding supervisory criticism can be particularly challenging.

3.3 Operational consistency

The operational application of qualitative default criteria requires robust governance and procedural discipline. Unlike IRB banks, Standardised Approach institutions may lack dedicated credit risk modelling teams or advanced monitoring tools (Basel Committee on Banking Supervision, 2019). This increases the risk of:

- Inconsistent classification across exposures and business lines.
- Discretionary delays in invoking default.
- Insufficient documentation of decisions.

Supervisory expectations underscore the need for documented criteria, segregation of duties and internal validation processes (European Central Bank, 2018).

3.4 Commercial conflicts of interest

Default classification also creates commercial tensions. Relationship managers may be reluctant to classify exposures as defaulted because of concerns about:

- Damaging long-standing borrower relationships.
- Accelerating repayment obligations.
- Triggering provisioning and capital impacts.

These conflicts can lead to "evergreening," whereby exposures are kept artificially performing to avoid recognition of credit deterioration (European Central Bank, 2017). Effective governance must therefore ensure that credit risk assessments remain independent of commercial considerations.

3.5 Group and Cross-Default effects

A further complexity arises in assessing whether default should extend to related entities within a group structure. Article 178 requires exposures to an obligor to be classified as defaulted once the condition is met, but does not mandate automatic cross-default to all affiliates. Institutions must assess whether economic dependence or control relationships warrant broader application (European Banking Authority, 2016). Consistency in these decisions is essential to avoid regulatory challenge and to ensure that credit risk is accurately reflected.

In summary, the "unlikely to pay" criterion requires institutions to balance regulatory expectations, commercial considerations and operational feasibility. For Standardised Approach banks, these challenges are compounded by limited modelling resources and heightened reliance on judgment, underscoring the importance of clear policies, governance structures and supervisory dialogue.

4. Implications for standardised approach banks

Although Article 178 CRR applies uniformly to all credit institutions, its operational and capital consequences differ markedly between Internal Ratings-Based (IRB) institutions and those applying the Standardised Approach. For Standardised Approach banks—typically smaller or mid-sized institutions—invoking the "unlikely to pay" criterion entails significant challenges and often disproportionate impacts relative to their risk management capacity and business scale.

4.1 Capital requirements and risk weighting

Under the Standardised Approach, credit risk exposures are assigned fixed regulatory risk weights based on counterparty classification and external credit ratings (European Union, 2013). Once an exposure is classified as defaulted, Article 127 CRR mandates application of a 150% risk weight, unless mitigated by eligible collateral or guarantees. This risk weight is substantially higher than the 35% or 75% typically assigned to performing exposures secured by residential mortgages or extended to retail borrowers, respectively.

The capital impact can be particularly severe for institutions with limited capital buffers. Even when partial collateral is available, the absence of an internal model to calibrate exposure at default (EAD) and loss given default (LGD) means that Standardised Approach banks cannot differentiate capital requirements based on granular risk assessments (Basel Committee on Banking Supervision, 2006). As a result, exposures with moderate credit deterioration may attract the same capital treatment as those with little prospect of recovery.

4.2 Impairment provisions under IFRS 9

In addition to regulatory capital consequences, default classification under Article 178 typically triggers classification as "credit-impaired" under IFRS 9 (International Accounting Standards Board, 2014). Accordingly, banks must recognise lifetime expected credit losses and maintain Stage 3 impairment provisions. For Standardised Approach banks, which often rely on simplified approaches or external benchmarks to estimate provisions, this can create significant operational burdens and financial volatility (European Central Bank, 2017).

Furthermore, the linkage between prudential and accounting frameworks underscores the importance of timely and accurate default classification. Delayed recognition may not only attract supervisory criticism but also compromise the integrity of financial reporting.

4.3 Reputational and relationship consequences

From a relationship management perspective, default classification has pronounced effects. For borrowers, the designation of default:

- Restricts access to additional credit facilities.
- May trigger cross-default clauses in agreements with other lenders.
- Carries reputational stigma that can impair business operations.

Standardised Approach banks, which often maintain closer commercial relationships with clients, must therefore navigate the tension between prudential compliance and preserving client confidence (European Banking Authority, 2016). Relationship managers may perceive early recognition of default as commercially damaging, which increases the risk of inconsistent application or delay.

4.4 Governance and resource constraints

While IRB institutions typically maintain dedicated credit risk departments and advanced modelling capacity, Standardised Approach banks may rely on smaller teams with limited specialisation. Consequently, operationalising the "unlikely to pay" criterion requires careful:

- Development of documented criteria and procedures.
- Segregation of duties between business functions and independent credit risk oversight.
- Ongoing staff training to ensure consistent application.

Supervisory expectations emphasise that all banks, regardless of size or approach, must demonstrate robust governance and procedural discipline in default recognition (European Central Bank, 2018). However, achieving this in practice often requires investments in systems and processes that can strain the resources of smaller institutions.

4.5 Competitive and strategic considerations

Finally, default recognition under Article 178 May impact competitive dynamics within the banking sector. IRB banks can model risk weights more precisely, thereby optimising capital allocation across exposures. In contrast, Standardised Approach banks are constrained to fixed risk weights, which can result in disproportionately higher capital consumption and reduced lending capacity (Basel Committee on Banking Supervision, 2019). Over time, these constraints may affect pricing, profitability and the bank's strategic positioning in key lending segments.

In aggregate, these implications highlight that while the regulatory definition of default seeks consistency and prudence, its operationalisation requires Standardised Approach banks to balance regulatory compliance, commercial viability and proportionality. Addressing these challenges demands strong governance, clear policies and transparent engagement with both supervisors and clients.

5. Case illustrations

This section presents three stylised case examples illustrating how Standardised Approach banks interpret and operationalise the "unlikely to pay" criterion under Article 178 CRR. Each example is hypothetical but reflects realistic scenarios aligned with regulatory principles and supervisory expectations.

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5.1 FerroTech GmbH

5.1.1 Context and background. CentraBank AG is a regional credit institution operating in a euro area Member State. The bank primarily serves small and medium-sized enterprises (SMEs) and mid-market corporate clients, applying the Standardised Approach for credit risk capital calculation. CentraBank maintains a Common Equity Tier 1 (CET1) capital ratio of 11.8%, which exceeds regulatory minimums but leaves limited headroom relative to larger institutions.

One of CentraBank's significant borrowers, FerroTech GmbH, is a manufacturer of industrial equipment with the following exposures:

- €12m term loan secured by machinery and receivables;
- €3m revolving credit facility (RCF) unsecured; and
- €1m trade finance facility.

Prior to the events described, FerroTech was assigned an internal risk rating equivalent to "Investment Grade," and the exposures attracted risk weights of 75% (unsecured) and 50% (secured).

5.1.2 Early warning indicators. During a periodic credit review, the relationship manager identified several concerning developments:

- A breach of a financial covenant related to leverage.
- A decline in cash reserves to less than €500,000.
- A request for a six-month deferral of interest payments on the term loan.
- Disclosure of plans to sell non-core business units to raise liquidity.

The Credit Risk Department classified the case as requiring enhanced monitoring and initiated a formal assessment under Article 178.

5.1.3 Assessment of "unlikely to pay". CentraBank evaluated whether the exposures met the criteria for default. Applying the European Banking Authority (2016), the Credit Committee considered:

- The combination of covenant breach and liquidity deterioration.
- The request for concessions indicating potential distressed restructuring.
- The uncertain outlook for planned asset sales.

Following deliberation, the Credit Committee concluded that repayment in full without collateral realisation was unlikely and approved default classification under Article 178(b).

5.1.4 Capital and provisioning impact. The default classification triggered significant operational and financial consequences:

- Risk Weighting: All exposures were reclassified as defaulted. The applicable risk weight increased to 150% for €16m in total exposures, raising risk-weighted assets by €11.2m.
- Impairment Provisions: Under IFRS 9, the exposures were designated as credit-impaired (Stage 3), requiring recognition of lifetime expected credit losses. A provision of €5.6m was recorded based on collateral valuations and recovery estimates (International Accounting Standards Board, 2014).
- Capital Adequacy: The combined effect of higher risk-weighted assets and provisions reduced the CET1 ratio to 10.9%, materially narrowing CentraBank's capital buffer.

5.1.5 Relationship and reputational effects. FerroTech's management disputed the default designation, arguing that the requested concessions were precautionary. The classification triggered cross-default clauses in other agreements, prompting the withdrawal of credit lines from other lenders and accelerating liquidity pressures. Within three months, FerroTech entered insolvency proceedings.

From CentraBank's perspective, early recognition aligned with regulatory expectations and ensured provisioning adequacy. However, the case revealed tensions between prudential compliance and commercial objectives. Relationship managers expressed concern that the bank's perceived lack of flexibility contributed to the borrower's collapse, potentially damaging CentraBank's reputation among other clients.

5.1.6 Lessons learned. The FerroTech case underscores several lessons relevant to Standardised Approach institutions:

- Even when payments remain up to date and no significant arrears have accrued, qualitative indicators—such as borrower stress, operational concerns or industry signals—may necessitate default recognition under Article 178.
- Default classification can materially impact capital adequacy, especially under the fixed 150% risk weight applied to defaulted exposures in the Standardised Approach.
- Consistency in applying default triggers, transparent governance and well-documented internal assessments are essential. These help manage the regulatory, operational and reputational consequences of default decisions and support supervisory expectations for auditability and back-testing.

5.2 Retail SME borrower

To illustrate how default recognition challenges arise in smaller exposures, consider CentraBank's unsecured loan to a retail SME client. GreenLeaf Organics is a family-owned business operating several organic food shops in the region. The exposure comprised:

- €500,000 working capital loan with a 12-month tenor.
- €100,000 overdraft facility secured against business receivables.

During a routine monitoring cycle, the relationship manager observed that GreenLeaf had experienced a significant decline in sales due to unseasonal weather and supply chain disruptions. The borrower submitted financial statements showing negative cash flow over the prior two quarters.

Although payments remained current, GreenLeaf formally requested a three-month interest moratorium and temporary overdraft limit increase to manage liquidity. The Credit Risk Department assessed the situation in accordance with Article 178 and EBA Guidelines (European Banking Authority, 2016).

Key considerations included:

- The borrower's request for a concession was driven by liquidity stress but no formal insolvency proceedings had been initiated.
- Financial statements showed a negative equity position and persistent covenant breaches.
- Management presented a credible plan to improve cash flow through cost reductions and supplier renegotiations.

After deliberation, the Credit Committee determined that repayment was still likely without recourse to collateral realisation. The exposure was classified as performing but flagged for

enhanced monitoring. However, the Committee also resolved that if cash flow did not improve within three months, the request for additional concessions would trigger the "unlikely to pay" criterion.

5.2.1 Lessons learned. This example demonstrates the importance of distinguishing between temporary liquidity stress and structural credit deterioration in SME lending. It also underscores that consistent escalation processes and clearly defined thresholds are essential to avoid delayed recognition when further concessions are sought.

5.3 Commercial real estate developer
A further example involves CentraBank's exposure to a mid-sized real estate developer, EuroHabitat Group, which specialised in commercial property projects. The exposure consisted of:

- €8m term loan secured by mortgages over completed properties; and
- €2m revolving construction finance facility.

EuroHabitat's financial performance deteriorated following a sharp decline in rental income due to market oversupply and prolonged vacancies. An updated property valuation indicated that collateral values had fallen by 25% relative to the original appraisal.

Additional early warning indicators included:

- breach of the loan-to-value covenant;
- delays in project completion due to contractor insolvency; and
- a request for a 12-month extension of the loan maturity date.

The Credit Risk Department conducted a comprehensive review, considering both quantitative metrics and qualitative factors. Under European Banking Authority (2016), distressed restructuring requests and covenant breaches are strong indicators of unlikely to pay. However, the developer maintained significant unencumbered assets and a committed refinancing plan supported by external investors.

After evaluating the borrower's plan, the Credit Committee classified the exposure as performing but assigned it to intensive monitoring. Six months later, when the refinancing failed and rental income continued to decline, the bank concluded that repayment in full without collateral realisation was unlikely. The exposure was classified as defaulted under Article 178(b).

5.3.1 Lessons learned. The EuroHabitat case highlights how collateral valuations and refinancing viability must be integrated into qualitative default assessments. It reinforces the need for ongoing monitoring and readiness to reclassify exposures if recovery strategies fail.

6. International perspectives
While Article 178 CRR establishes a harmonised definition of default within the European Union, other jurisdictions adopt comparable principles with variations in regulatory detail, supervisory emphasis and operational expectations. Reviewing these frameworks highlights both convergence in core principles and divergence in implementation approaches, especially concerning proportionality and supervisory discretion.

6.1 United Kingdom: PRA approach Post-Brexit
Following the UK's withdrawal from the European Union, the Prudential Regulation Authority (PRA) retained a consistent approach to default recognition under the retained EU

law version of the CRR. The PRA's Supervisory Statement SS11/13 confirms that the 90-day past-due threshold and the qualitative "unlikely to pay" criterion continue to apply Prudential Regulation Authority, (2021). However, recent PRA consultation papers have emphasised proportionality and the importance of clear governance processes for smaller firms. In its thematic reviews, the PRA has also expressed concern about inconsistent interpretation of qualitative default indicators and has encouraged institutions to establish comprehensive policies supported by staff training.

6.2 United States: OCC and federal reserve frameworks

In the USA, credit classification is primarily determined through supervisory guidance rather than codified regulation equivalent to Article 178. The OCC requires unsecured retail exposures to be charged off after 120–180 days past due, while commercial credits are assessed based on examiner judgment using classifications such as "substandard," "doubtful," or "loss" (Office of the Comptroller of the Currency, 2000). The Federal Reserve's Commercial Bank Examination Manual provides further guidance on assessing borrower viability, including qualitative considerations similar to "unlikely to pay." Notably, the U.S. system grants examiners substantial discretion in determining whether repayment is unlikely, reflecting a more judgment-based supervisory culture (Board of Governors of the Federal Reserve System, 2015).

6.3 Australia: APRA prudential standards

The Australian Prudential Regulation Authority (APRA) requires banks to classify exposures as defaulted when obligations are 90 days past due or when repayment is unlikely without realising security (Australian Prudential Regulation Authority, 2022). APRA has also published guidance clarifying that distressed restructures, covenant breaches and adverse changes in financial condition should be explicitly considered as triggers. Enforcement actions by APRA have demonstrated the expectation that even smaller institutions maintain clear governance over default classification.

6.4 Singapore: MAS guidance

The Monetary Authority of Singapore (MAS) maintains broadly similar principles under MAS Notice 612, combining objective delinquency thresholds and qualitative indicators (Monetary Authority of Singapore, 2017). MAS also emphasises consistency with Singapore Financial Reporting Standards (SFRS) and requires detailed documentation of credit risk assessments. Supervisory reviews have underscored the need for integration of prudential and accounting processes.

6.5 Comparative observations

While core Basel principles are widely adopted, jurisdictions differ in their operational expectations and degree of supervisory discretion. The U.S. and Australia permit greater reliance on examiner judgment, while the EU and Singapore frameworks are more prescriptive. These differences highlight that while prudential consistency is a shared goal, implementation must reflect institutional capacity, supervisory culture and legal frameworks. For European Standardised Approach banks, these international perspectives underscore the importance of clear policies, proportionate governance expectations and ongoing supervisory engagement to manage the complexities of qualitative default recognition.

6.6 Basel IV considerations

The ongoing implementation of the Basel IV framework, particularly the finalised standards on credit risk and output floor adjustments, has important implications for proportionality in the context of the Standardised Approach across jurisdictions. As jurisdictions calibrate their national transpositions of Basel IV, differences in supervisory expectations for smaller or non-IRB institutions may influence how proportionality is interpreted in practice. In several regions, including the EU and Australia, regulators have indicated that Basel IV's enhanced risk sensitivity must be balanced with pragmatic implementation for smaller banks, reinforcing the importance of scalable governance and simplified documentation frameworks (Basel Committee on Banking Supervision, 2022; European Banking Authority, 2023). These developments suggest that proportionality under Basel IV will remain a dynamic concept, shaped by both supervisory discretion and the evolving design of the Standardised Approach. Keeping these in mind, in 2025 the European Banking Authority (EBA) launched a review of the default recognition guidelines under Article 178, highlighting the evolving nature of supervisory expectations under the broader Basel IV reforms (European Banking Authority, 2025).

7. Policy and governance recommendations

The analysis presented in this paper demonstrates that invoking the "unlikely to pay" criterion under Article 178 CRR introduces interpretive ambiguity, operational inconsistency and potentially disproportionate impacts for Standardised Approach banks. To address these challenges, institutions and supervisors can adopt targeted measures to strengthen governance, improve consistency and uphold proportionality without compromising prudence.

7.1 Codify clear operational criteria

Banks should translate the principles of Article 178 and the EBA Guidelines into precise, documented criteria that are tailored to their portfolios and risk profiles (European Banking Authority, 2016). Policies should include:

- Structured lists of qualitative triggers, such as evidence of significant financial difficulty, distressed restructurings or persistent covenant breaches.
- Quantitative thresholds to assess materiality and severity.
- Decision frameworks to support timely escalation and consistent application.

Emerging technology solutions can also be leveraged to codify triggers within credit monitoring systems, enabling early identification of risk indicators through data analytics.

7.2 Strengthen governance and segregation of duties

Robust governance requires clear segregation between origination and credit risk oversight functions. Credit classification decisions invoking qualitative criteria should be independently reviewed by a Credit Committee or second line of defence, with clear documentation of supporting evidence (European Central Bank, 2017). Smaller institutions should implement proportionate oversight structures, such as centralised credit policy teams, to maintain consistency.

7.3 Enhance training and awareness

Regular training is essential to equip staff with the skills to exercise judgment in borderline cases. Training programmes should:

- Cover relevant regulatory frameworks and accounting standards.
- Present case studies illustrating early warning indicators and qualitative default triggers.
- Reinforce the importance of timely recognition and transparent borrower communication.

Peer learning and scenario-based workshops can also improve confidence in applying criteria consistently.

7.4 Proportional implementation for smaller institutions

Supervisory guidance should explicitly recognise proportionality in expectations for smaller banks (European Central Bank, 2018). For example:

- Simplified documentation templates can reduce the burden of record-keeping.
- Standardised checklists can support smaller teams without extensive modelling resources.
- Supervisory engagement can focus on education and thematic feedback rather than solely on enforcement.

This approach balances prudence with operational feasibility and encourages smaller institutions to embed effective practices without undue strain.

7.5 Foster transparent borrower communication

Transparent communication with borrowers helps manage reputational risks and supports recovery prospects. Banks should provide clear explanations when default classification is under consideration and outline remediation options where appropriate. Digital channels can complement traditional communications, enabling timely and documented engagement.

7.6 Integrate prudential and accounting processes

Given the linkage between default recognition and IFRS 9 Stage 3 classification, institutions should develop integrated workflows to ensure alignment of provisioning, reporting and regulatory capital calculations (International Accounting Standards Board, 2014). This integration enhances data consistency, improves audit readiness and supports clear governance oversight.

7.7 Encourage ongoing supervisory dialogue

Supervisors play a critical role in reinforcing expectations and supporting consistency. Regular thematic reviews, guidance updates and open dialogue can help institutions benchmark practices, share lessons learned and improve transparency (European Central Bank, 2017). Recent studies show that banking supervisors must continuously adapt their frameworks in response to changes in accounting and regulatory norms. (Dedeloudis and Hardouvelis, 2025).

These recommendations provide a roadmap for Standardised Approach banks to strengthen their default recognition frameworks and manage the operational challenges inherent in applying qualitative criteria under Article 178 CRR.

8. Conclusion

The recognition of default under Article 178 of the Capital Requirements Regulation represents a critical intersection of prudential regulation, accounting standards and credit risk management practices in European banking. While the regulatory definition seeks to ensure

consistency and transparency, the application of the "unlikely to pay" criterion introduces interpretive challenges that are particularly acute for Standardised Approach banks.

This paper has demonstrated that for such institutions, default recognition carries disproportionately significant implications. The fixed 150% risk weight applied to defaulted exposures increases capital consumption, while the parallel requirement to classify exposures as credit-impaired under IFRS 9 necessitates substantial provisioning. These consequences, combined with reputational and relationship considerations, highlight the operational tension between prudence and proportionality.

The analysis underscores that the challenges of default recognition are not confined to technical compliance. They extend to governance structures, staff training and the management of borrower relationships. International perspectives illustrate that while similar regulatory principles are applied globally, supervisory expectations and degrees of discretion differ, offering potential lessons for European practice.

To address these issues, the paper has proposed a set of recommendations: codifying operational criteria, strengthening governance independence, enhancing staff awareness, fostering transparent borrower communication and ensuring proportional implementation tailored to smaller institutions. These measures aim to balance the legitimate supervisory imperative for timely recognition of credit deterioration with the need to maintain operational feasibility and competitive viability.

Ultimately, effective default recognition is not only a regulatory obligation but also a cornerstone of sound credit risk management. As supervisors and institutions continue to refine their approaches, ongoing dialogue, proportionality and transparency will be essential to uphold the resilience of the European banking system.

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