

Definition of Default – Are we overdoing it? A critical examination of evolving regulatory frameworks and credit risk management practices in the IRB approach

Abstract

The Definition of Default (DoD) plays a pivotal role in the Internal Ratings-Based (IRB) approach to credit risk management, impacting key metrics such as capital adequacy, risk-weighted assets (RWAs) and overall credit risk assessments. However, with the evolving regulatory landscape, the definition of default is becoming more complex, leading to potential misclassifications of entities, adding significant overhead to constructing a compliant DoD and impacting firms' risk management practices.

This paper examines how these regulatory frameworks diverge from real-world credit risk practices, particularly across different generations of and jurisdictions' regulatory frameworks, and the consequences of the overhead of tighter DoDs and of their resultant misclassifications (i.e. Type 1 errors in default). We explore the relatively low uplift in default volumes from newer and more expansive DoDs but weigh this against the likely concerns of regulators in constructing these new rules and consider whether a low uplift implies strong existing credit risk practices and rules which already capture the spirit of the regulations.

Through cross-jurisdictional comparisons and case studies, we further explore whether some conservative definitions' components may be disproportionately penalising firms that are in temporary, or mild financial distress and thereby misaligning regulatory capital with actual credit risk. The paper concludes with recommendations for refining the DoD to better reflect true credit risk and improve alignment between regulatory requirements and internal risk management practices.

Authors & Affiliations

Mr Alexander Whitehouse¹, Dr Writam Chakraborty¹

¹True North Partners, London, United Kingdom