Regulatory Blog

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The EBA’s plan to tackle off-balance sheet items: crucial EBA consultation on the allocation of off-balance sheet items and unconditionally cancellable commitments under CRR 3

There is not much time left until the implementation of CRR 3.

Under the Capital Requirements Regulation (CRR 3) the European Banking Authority (EBA) has initiated a public consultation on its **draft Regulatory Technical Standards (RTS) related to off-balance sheet items under the standardised approach for credit risk (SA-CR)**. These standards outline the criteria for institutions to classify off-balance sheet items, unless specifically detailed in Annex I of the CRR. Additionally, they define factors that could limit institutions' capacity to cancel unconditionally cancellable commitments (UCC).

This consultation's significance is particularly noteworthy in the context of the revised CRR 3 regulations on Credit Conversion Factors (CCFs). The elimination of the 0 % CCF for low-risk items (now referred to as Bucket 5) stands out as a key modification in CRR 3. Considering that the future 10 % CCF floor also applies to UCCs, the regulations on the allocation of UCCs to the buckets, as well as the factors that may constrain institutions' ability to cancel UCCs, are of particular importance. Furthermore, the consultation addresses current legal uncertainties regarding the allocation of off-balance sheet items into Buckets 1, 2, 3 and 5. With these contents, the publication has far-reaching implications for the procedural handling of CCFs (from identification to monitoring and documentation) as well as direct and significant consequences for Risk-Weighted Assets (RWA) and capital.

The consultation is part of the first phase of the EBA roadmap for implementing the EU banking package and CRR 3. Comments to the consultation can be sent to EBA until 4th June 2024.

Background

According to Article 111 CRR, the exposure value of an off-balance sheet position is determined by multiplying the nominal value, after deducting specific credit risk adjustments and amounts deducted according to Article 36(1)(m) CRR, with the corresponding percentages. These different percentages reflect the riskiness of the positions, i.e., the likelihood that a financial institution will be called upon from an off-balance sheet position. Therefore, the percentages play a crucial role in calculating the Risk-Weighted Assets (RWA), as they directly impact the amount of capital that financial institutions must maintain to cover their credit risk exposures.

With the introduction of CRR 3, amendments are made to update the calibration of applicable percentages. This results in the implementation of an adjusted weighting scheme and an expansion of the number of buckets from 4 to 5 leading to the conversion factor of 100 %, 50 %, 40 %, 20 % or 10 %. The categorization of off-balance sheet items into these buckets follows a mapping detailed in Annex I of the CRR 3. Further Article 5 (9) of the CRR 3 introduces a definition for the term "commitment".

EBA's consultation on off-balance sheet items and UCC

The EBA is mandated with developing RTS that define the following:

1. The criteria to assign off-balance sheet items to the buckets 1 to 5

While the CRR does not specifically refer to CCFs under the SA-CR, but percentages, they are used similarly to the CCFs within the IRB approach to convert an off-balance sheet amount into an on-balance sheet equivalent amount. Therefore, the interpretation of those percentages is facilitated by acknowledging the conditionality of the applicable percentage to the default of the obligor.

Further, the concept of conditionality to events shall better help allocating percentages to off-balance sheet items that are not specified in Annex I, by setting up a hierarchy based on the type of conditional events that need to happen for an institution to become exposed to the risk of credit losses in case of a default event.

The RTS states that as general guidance, the associated percentages depend on whether becoming exposed to the risk of credit losses in case of a default event is additionally conditional on the occurrence of a non-credit risk related event that is described in the contractual terms.

Bucket 1 covers off-balance sheet exposures where the exposure to the risk of credit losses in case of default is not conditional on the occurrence of any non-credit risk related event that still needs to take place. This includes commitments that are considered credit substitutes.

In contrast, **bucket 2** covers contingent items where the exposure to the risk of credit losses in case of default depends on the occurrence of at least one event that is not related to credit risk but has not occurred yet before a default of the obligor could cause losses to the institutions. Once it occurs, the exposure does no longer depend on the occurrence of any non-credit risk related condition that still needs to be fulfilled, then the item would be categorized as **bucket 1** if not converted into an on-balance sheet item. However, drawing from a commitment is not considered as a contingent event.

For instance, an institution issues a guarantee to compensate the owner of a property if the tenant fails to return it in good condition and fails to pay the compensation. Initially, the item is classified under bucket 2 with a 50 % allocation, as long as the non-credit risk condition is not met. However, if the property is returned in a bad condition, it would be reclassified under bucket 1 with a 100 % allocation or become an on-balance sheet item, depending on the accounting framework. This reclassification is due to the guarantee provided by the institution, which covers the tenant's obligation to pay compensation. Therefore, the allocation of the item depends on whether the contingent event has occurred or not.

A commitment that is not a credit substitute may be assigned to bucket 3 or bucket 5 depending on if it meets the definition of UCC. Commitments not falling under another category are allocated to **bucket 3** and UCCs are allocated to **bucket 5**.

Further, a non-exhaustive list of specific off-balance sheet items is also included in the consultation paper.

However, the consultation paper lacks specific details regarding off-balance sheet items that may potentially be categorized as **bucket 4** (trade finance). At present, there are still uncertainties surrounding the assignment of these items to the bucket.

2. The factors that may constrain the institutions' ability to cancel UCCs

The RTS specifies the following factors that may limit the ability of an institution to cancel UCCs thus setting out risks to categorizing off-balance sheet items as UCCs:

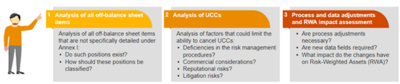
- Deficiencies in the risk management procedures, including shortcomings in the credit risk monitoring framework and in the IT systems and processes.
- Commercial considerations aimed at avoiding negative impacts on the creditworthiness of the clients or on the business relationship with the clients.
- Reputational risks, whereby commitments are not being cancelled by the institutions with a view to avoid creating a potential negative perception vis-a-vis market-participants.

3. The process for notifying EBA about the institutions' classification of other off-balance sheet items carrying similar risks as those referred to in Annex I

While the requirement to inform the EBA about the classification of certain products has been a part of the CRR text for quite some time, a reporting process has never been formally established. This is also addressed by the consultation which requires institutions to notify EBA in accordance with the ITS on supervisory reporting (EU) 2021/451. Therefore, it seems likely that the COREP reporting forms will be adapted to include relevant information.

Next steps

There is not much time left until the implementation of CRR 3. To meet the requirements on an equal footing, we propose the following action points:



Stakeholders will have the chance to provide feedback on this consultation until 4 June 2024.

You have questions regarding the consultation paper or want to discuss your views? Please reach out to us. Our team of CRR 3 and credit risk experts is happy to support you!

Get ongoing updates on the topic via regulatory horizon scanning in our research application, PwC Plus. Read more about the opportunities and offerings **here**.

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Schlagwörter

Capital Requirements Regulation (CRR III), Credit Risk, Internal ratings-based approach (IRBA), Regulatory Reporting, SA-CCR

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