Warsaw, 31 May 2024

 European Banking Authority

**The response of Polish Bank Association to**

**Draft Regulatory Technical Standards on the allocation of off-balance sheet items and UCC considerations under CRR3**

<https://www.eba.europa.eu/activities/single-rulebook/regulatory-activities/credit-risk/regulatory-technical-standards-allocation-balance-sheet-items-and-ucc-considerations>

**(deadline 04.06.2024)**

The Polish Bank Association welcomes the opportunity to express its opinion in the EBA Consultation on the Regulatory Technical Standards (hereinafter: RTS) on the allocation of off-balance sheet items and UCC considerations under CRR3  regarding off-balance sheet items under the standardised approach of credit risk provide the criteria that institutions shall use to classify off-balance sheet items, unless explicitly specified in Annex 1 of the CRR.

*Question 1. Do you have any comment on the non-exhaustive list of examples provided?*

We kindly ask for clarification of the proposed Article 1 (3) and the non-exhaustive list of specific off-balance sheet items included in the Consultation Paper.

In our opinion in any case there is no obligation to the client to withdraw funds from the loan as the client may always resign from launching measures from credit.

What should be understood by certain amounts that client must draw in the future?

The reason for allocation to bucket 1 “forward starting loans” is unclear, as:

* this requirement will effectively double the CCF factor applied to such loans (from current 50% *resulting from “undrawn credit facilities (…) with an original maturity of more than one year”* to 100% (as bucket 1 item),
* such (new) treatment of these loans is not justified by the actual risks generated by these loans,
* it may lead to a misleading increase in RWA in the sector when applied and
* such requirement may create an incentive to remodel contracts templates by removing arrangements regarding the obligation of the client to draw certain amounts at certain points in time, which will generally increase the risk of such loans for the banks as the inclusion in the contracts of such provisions is generally prudentially beneficial (they often cover requirements of the completion of various stages of the investment process by the client, before time of the drawdown, and give the banks a partial assurance, that client operates according to the previously agreed schedule).

Additionally we believe that the non-exhaustive list of examples should cover also other buckets of products especially trade related products that should be included in bucket 4 since we are facing lack of clarity resulting in distortion of single market. Current definition of trade finance remains to large extent open-ended. Further clarification regarding the maximum expiry date (trade finance definition says ‘generally of less than one year’) and understanding of ‘exchange of goods and services’ would be desired.

The use of an illustrative example of a product described as a “mortgage” in paragraphs 16 and 17 is confusing/misleading. The scenario describes “a mortgage loan offer provided by a bank but not yet accepted by the client, where the contractual arrangement specifies a certain amount must be drawn at a future point in time”. For typical mortgage offers, even after the acceptance of the letter of offer by the customer, the customer is under no obligation to draw down the funds and can withdraw at any time before completion of the house purchase. Indeed, the drawdown of the mortgage remains contingent on the completion of the property purchase – after which point, the exposure ceases to be an off-balance sheet commitment and becomes an on-balance sheet exposure. i.e. mortgage offers are not direct credit substitutes.

As such, this more typical mortgage example should be in bucket 3, and it would be useful to see this added to this list of examples provided, e.g. “Residential mortgage offer because this is contractual arrangement to extend credit, hence falls under the definition of commitment under article 5(9) while not being a credit substitute.”

We would like to ask for clarification regarding bucket 3. Currently, only revolving limits granted for overdraft on current accounts are included as an example. However, it seems that all revolving loans and credit cards work in the same way and should be included in bucket 3, as drawing from these products depends entirely on the clients’ decision.

*Question 2. Which is the average period of time given to the client to accept the mortgage loan offer?*

We do not have such kind of statistical data. The practice is different in banks and depends on the situation on the market.

*Question 3. What is the applicable percentage that institution currently apply to these cmmitments?*

We do not have such kind of statistical data. The practice is different in banks and depends on the situation on the market.

For institutions using the standardised approach (SA) in relation to mortgage loans:

* accepted offers - the applicable CCF is dependent on the original maturity of the loan as per the current CRR Annex I: 20% if the original maturity is below one year and 50% if it’s higher than one year(this treatment has been confirmed by EBA Q&A 2022\_6602 ‘’Estimation of a conversion factor for binding mortgages under the IRB Approach’’).
* not accepted contractual arrangements (that under CRR3 should be treated as credit exposure) – currently not included in RWA calculation.

Indeed, the definition of a commitment brought by CRR3 relies on the acceptance of a contractual arrangement by the client and Article 111(4) specifically aims at specifying that, even if not yet accepted by the client, the item should be treated indifferently as a commitment. There is no intent here to impact the CCF that is to be applied to the given type of commitment as per Annex I.

 *Question 4. What is the average acceptance rate by the client of a mortgage loan offered by the bank?*

We do not have such kind of statistical data. The practice is different in banks and depends on the situation on the market.

There is no certainty around drawing that would justify a 100% CCF and the bucket 3 seems the most relevant bucket as specified by CRR3 Annex I. In particular the fact that the client can revoke reduces the likelihood of it being drawn, which makes a 40% CCF more appropriate.

A 100% CCF would mean that every offer made by a bank will be accepted by every client. As a result, all banks that issued binding offer to the client (distributed credit decision to the client), would consume capital for a single mortgage.

In our opinion there is the doubt if the EBA is not going beyond its mandate and is contradicting CRR3 rules which allocate mortgage loan offers to the bucket 3, given that in our opinion undrawn mortgage loan accepted by the client already falls into this category. In fact, regardless of statistical average, the application of a 100% CCF ahead of acceptance and even ahead of drawing once the mortgage offer is accepted may be potentially incoherent with the legal framework.

The MCD transposition in local jurisdictions may allow that:

1. once the offer is made by the bank, the client has a right of reflection - meaning there may also be contingency in relation to the fact that the client does not accept another offer from another bank;
2. once accepted, the client can still revoke the contractual agreement (without penalty), should the real estate sale not occur.

Application of 100% CCF means that every offer made by a bank will be accepted by every client. As a result, all banks contacted by the client, within its legal right to compare different offers, would consume capital for a single mortgage. This demonstrates that the average acceptance rate is under 100%. Hence, a 100% CCF is disproportionate, and does not reflect the actual risk of institutions.

The customer's right to compare means that there is no certainty on the final acceptance, so the CCF should not be 100%.

*Question 5. Do you have any comment on the allocation criteria proposed under Article 1?*

The formulation of Article 1.1 of the draft RTS is extremely wide. Indeed, the literal reading of this article would mean that any off-balance sheet item not linked to a non-credit related event would fall under the bucket 1~~at~~ category, including a financing commitment or a revolving credit facility, while we understand, based on the background document, that the EBA is targeting credit substitute guarantees or part of financing commitments with mandatory drawings. **We therefore suggest EBA to modify Article 1.1 by precising that it applies to contingent commitments and not to funding commitments.**

Similarly, Article 1.2 as currently drafted will capture all the other off-balance sheet items that are not trade finance related and whose materialization is contingent to a non-credit risk related event that has not yet occurred. For instance, this bucket will capture a financing commitment whose possible drawdown is linked to an administrative agreement, while this type of commitment should be captured under the bucket 3 (40% CCF). **We suggest the EBA to modify article 1.2 by precising that this article should apply only to contingent transaction-related commitment (excluding trade finance commitments) which are not funding commitments.**

It requires clarification whether contractual arrangements offered by an institution (but not yet accepted by the client, that would become commitments if they are accepted by the client), and to what extent (if any), would fall under the scope of article 1. Especially in case of contractual arrangements offered, it is doubtful that the institution could assess (at this point of the credit process), whether its exposure to the risk of credit losses in the event of default of the obligor is (or is not) contingent to non-credit risk related event (and to how many).

How to interpret the concept of "the amount that must be drawn"?

 A literal interpretation may lead to the conclusion that there are no cases of obligatory drawdowns for borrower, therefore the second sentence of the first paragraph in Annex I bucket 1:" In those cases where the amount that must be drawn is lower than the full committed amount, only the amount that must be drawn is to be allocated under bucket 1” would be confusing on how to be applicable.  Drawing is not an obligation of the client (must draw) but his right (may draw/utilise) and moreover it is conditional on its obligation to meet all conditions of utilization the loan. This is important in the context of different classification of amounts (off-balance sheet items)  into individual bucket depending on whether the amount had to/could be drawn (utilise) or not.

Criteria for the allocation of "offers" to a given bucket

If offers mean contractual arrangements offered by an institution, but not yet accepted by the client (that would become commitments if accepted by the client, it generates some questions:

What shall the offer contain in order to be classified to the relevant bucket? Does it mean that the content of the offer shall include clauses that will allow the offer to be unconditionally revoked at any time (before signing the facility agreement) or is it enough that contractual arrangements contain these clauses, regardless of the fact that the offer itself cannot be revoked without the customer's consent.

According to the law offer without the client's consent is irrevocable and the proposed provisions on unconditional revocation are not yet valid, until it is accepted by client.

***Question 6****. Do you have any suggestion regarding allocation criteria for buckets 4 and 5?*

Does "and related regulation/legislation" refers to other provisions of law/regulation in the area of consumer protection or does it indicate other possible provisions regarding the granting of credit to any entity other than a consumer?

The question concerns the interpretation of the concept of unconditionally cancelable commitments (UCC).

Pursuant to Art. 5(b)(10) "unconditionally cancelable commitments" means any commitment the terms of which permit the institution to cancel that commitment to the full extent allowable under consumer protection and related regulations at any time without prior notice to the obligor**, or** that effectively provide for its automatic cancellation due to the deterioration in the  borrower's creditworthiness.

The second part of the definition after the word "or" – i.e. “that effectively provide for its automatic cancellation due to deterioration of the borrower`s creditworthiness” , indicates that there must be a deterioration in creditworthiness in order to automatically cancel the unused commitment, so we cannot talk about "unconditionality".

Historically, in Annex I to the CRR, low-risk items in point 4(a), second sentence, referred to consumers only: "Retail lines of credit may be considered unconditionally cancellable, if the terms of the contract allow the institution to cancel it to the full extent permitted by legislation on consumer protection and related matters.

In art. 5 b) point 10, the first part of the sentence does not refer to retail lines, so it can be considered that these are all types of credit agreements, regulated by national provisions with corporate client as well.

***Question 7****. Do you have any comment on the factors that may constrain* *unconditionally cancellable commitments* *proposed under Article 2?*

We would like to draw EBA`s attention to a problem that may arise in connection with the term "offer" (Article 111(4) of the CRR3). RTS introduces the principle: Contractual arrangements that have not yet been accepted by the client fall within the scope of obligations and should be treated in the same way as if they had been accepted. In particular, this means that the same CCF value is used as for the accepted contractual arrangements.

Including the offer in the calculation of capital requirements in a similar way to commitments, creates the need to maintain additional capital requirements by each bank that has prepared such an offer for a specific client, which limits the availability of capital to conduct banks' lending activities.

This is particularly important when registering binding offers of significant value (e.g. in the case of tenders or consortiums), where the final participation of individual banks is not yet known. If each bank has to register a binding offer in the nominal value offered to the customer, there will be duplication/partial duplication of the capital burden in banks.

We express some reflections concerning the proposed factors that may constrain unconditionally cancellable commitment proposed under Article 2:

1. The factors are vague and imprecise, and they give rise of risk of different interpretations by banks and the regulators.
2. Refer to risks that cannot be eliminated in banking processes,
3. In practice prevent banks from application of the Article 111 (8) of CRR,
4. Are all covered by capital requirement for operational risk.
5. What is the possible and allowed bank`s discretion in recognizing that one of the factors that may prevent the bank from canceling has been met and what quantification can be used: materiality? defined or specified in the bank's internal regulations? when the risk is 100% (and only when the probability of losing the dispute is estimated above 50%, resulting in the need to establish a reserve for legal risk when such a dispute occurs)?
6. How to assess whether there will actually be a loss of reputation due to non-cancellations when historically such events have not occurred and the trend has been more towards reputational damage due to unconditional cancellations?
7. Will the factor 2) refer to the "unconditionally cancelable commitment" if banks have to look at the deterioration of creditworthiness and the bank's assessment is not fully discretionary, as it may seem under the UCC based on the first part of the definition of UCC revocable in situations "permissible under consumer protection laws and related regulations."?
8. the bank recognizes various product groups as unconditionally cancellable commitments, e.g. unutilized factoring lines, financing agreements with MAC clauses or provisions of a similar nature or uncommitted financial lines.  RTS does not specify or differentiate the approach to assigning such products to individual bucket. Therefore, can it be assumed/interpreted that they can be treated uniformly for the purposes of classification into individual bucket?

Taking into account the above mentioned problems, we kindly ask to consider changing/clarifying these provisions.

**Guarantee classification.** The RTS does not precisely define the rules for classification into guarantee bucket.

Guarantees, including bid bonds and performance bond seems to be appear in both bucket 2 and bucket 4. The RTS provisions state that these products are classified in bucket 2, and if they are related to trade financing, then in stage 4. What should be the differentiation allocation criteria to correct bucket.

Should the granted guarantee limit be included in the same bucket as the granted guarantee? Based on RTS question 9, the guarantee is allocated to bucket 2 or 4. How to correctly classify the guarantee limit granted to the customer? Theoretically, it could be basket 3 as "unused amount of liabilities (...)".  However, we would then have a paradoxical situation where the guarantee gets a lower CCF of 20% from bucket 4 than the guarantee line, potentially 40% from bucket 3.

***Question 8****. Do you have any comment on the notification process proposed under Article 3?*

NA

***Question 9****. For credit institutions: What is the materiality in your institution of the off-balance sheet items that would fall under the categories “Other off-balance sheet items carrying similar risk and as communi-cated to EBA” listed in each bucket of Annex I?*

NA

Best regards

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