German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

EBA/CP/2024/08 Consultation on RTS on the allocation of off-balance sheet items and UCC considerations

German Lobby Register No R001459
EU Transparency Register No 52646912360-95

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Berlin, June 04, 2024

The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks.

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Overview of questions for consultation

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

We appreciate that EBA considers chargeback risk clearly not as a full risk item but we disagree with classifying it as an example for bucket 2 in Annex 1 of the CRR. As this is a highly disproportionate overestimation of the actual likelihood of such losses we propose the application of a 10% CCF for chargeback risk instead.

The following points underpin the classification as an item for bucket 5 in Annex 1:

1. The realization of a loss due to a chargeback event will only occur if:
   - a valid chargeback claim against the merchant is initiated, for example due to fraudulent behavior but not due to refunds from general cancellation rights or refunds under a warranty claims etc.; and
   - the default of the merchant has occurred and the merchant does not pay; and
   - there is no or only insufficient cash collateral from the merchant available

2. The actual observed chargeback rates in the industry are very low, way below 0.6 % overall. Chargeback rates vary per industry and are different for stationary versus online sales, and for some industries even less than 0.2 %. A detailed analysis of the chargebacks across merchant industries is performed by the respective card schemes on an ongoing basis. Furthermore, there is constant monitoring of merchants and their chargeback ratios in place and excessive chargebacks (max. 1 % resp. max. 1.5 %) can lead to the termination of the merchant's account. Lastly, it's not only in the interest of all involved parties to always strive for the highest security standards but also foreseen by the respective payment regulations like PSD 2 and PSD 3 etc. hence leading to lower fraud cases.

3. Fraudulent behavior is already covered by the CRR's capital requirements for operational risk. An unjustifiably high CCF for chargeback risk would lead to punitive double counting of this risk, even if it's related to fraud occurring in the sphere of the merchant and not directly involving the bank. If CRR-regulated banks are card acquirers, they also have to fulfill the respective AFC including fraud regulations. This also leads to exclusion of those industries with high chargeback risks.

4. Also to highlight is the major difference in capital treatment of chargeback risk that banks (i.e. CRR institutions) are facing compared to non-bank acquirers (i.e. payment institutions and e-money institutions – PI/EMI). The majority of acquiring service providers are registered as PI/EMI and regulated under the supervisory regime of the Payment Services Directive (PSD). Although a certain capital requirement is prescribed for those non-bank acquirers under PSD, the amount of capital is much smaller than what it would be even when applying only a of 10 % CCF. This leads to a significant business disadvantage for banks in the acquiring business, to increased costs for merchants and (mostly consumer) cardholders. In fact, the different capital treatment creates an unlevel-playing field between banks and non-banks offering acquiring services which, in the long-run, will not only disable banks from offering acquiring services for cards but also will impact their potential role as acquirer for the digital euro, which is also intended to be introduced with a chargeback approach.

5. Lastly, it is to note that the German Federal Financial Supervisory Authority (BaFin) in April 2022 has published an explanatory statement relating to chargeback risk for credit card payments and its capital treatment under CRR. BaFin issued this explanatory statement as the previously published EBA Q&A 2016_2916 left the applicable CCF for chargeback risk open. Out of the four possible risk items under CRR 2 and considering the 'very low chargeback ratios compared to transaction volumes' BaFin decided that treating chargeback risk as "medium/low risk item" with 20 % CCF (i.e. the lowest possible CCF above 0 %) would be adequate. As CRR 3 now offers five buckets and the lowest bucket does not have a CCF of 0 % anymore, applying bucket 5 of Annex 1 of CRR 3 would not contradict the argumentation of this BaFin explanatory note.

We do not share the opinion that commitments to purchase fund shares or units (CIUs) are considered credit substitutes and should be categorised in Bucket 1. In contrast to the second bullet of the "non-exhaustive list of examples", the agreement to purchase CIUs is a unilateral declaration of commitment by the institution to make the funds called available in return for the receipt of fund units or shares in the event of a capital call by the CIU (cash call). The terms and conditions of the CIU (prospectus, investment agreement, subscription agreement) do not contain any obligation on the part of the CIU to call up the funds. This is because such commitments are primarily used for CIUs that invest in illiquid assets such as real estate and equity investments and not in exchange-traded securities, where the search for and conclusion of suitable investments takes time. If the CIU does not find any suitable investments or is not awarded a contract, it will not draw down any funds, meaning that the utilisation of commitments to purchase fund units or shares is "conditional on the occurrence of any non-credit risk related event". Accordingly, they are not covered by the explanations in point 6. Equating them with guarantees in particular is also not appropriate, as in the assumed event of a default by the CIU, only the units or shares already purchased are at risk. This is stipulated in the Level 1 text, as the off-balance sheet risk position from the commitment to purchase fund units or shares in accordance with Art. 132c (1) CRR receives the risk weight of the CIU to be converted to, which is calculated in accordance with Art. 132a CRR from the underlying, not the possible future, risk positions (current fund composition). Rather, a categorisation in Bucket 3 similar to the "takeover bid" example is appropriate. On the one hand, both cases are "conditional on the occurrence of any non-credit risk related event", namely that the intended investment materialises. And secondly, "The purchase of assets falls under the definition of commitment under CRR article 5(9), which through Level 1 guidance in Annex I of the CRR is to be assigned to bucket 3, as not elsewhere classified.", as there is no other classification of commitments to subscribe to fund units except in the example of this consultation paper.

For contingent items where all relevant non-credit related events have been triggered the EBA proposes a re-categorization from bucket 2 to bucket 1 after the occurrence of the non-credit risk related event. This clarification should be deleted from the list. From our point of view the occurrence of such an event should not alter the CCF applicable to the instrument.

First of all, a re-categorization would contradict the clear wording of the legal text, where certain instruments are explicitly mentioned (performance bond, bid bonds, etc.). Those instruments do not change their nature i.e. cease to be a performance bond, bid bond, etc. after the occurrence of the non-credit risk related event.

Furthermore, a re-categorization would contradict the system and composition of Annex I. From our point of view it would make little sense to differentiate between performance bonds, bid bonds, warranties, etc. on one hand and credit substitutes on the other if any of the former would always be able to become the later. The explanation given in 3.1 of the consultation paper, as we see it, is ignoring the fact that not only the mentioned example but all guarantees at one point could possibly be drawn conditionally only on the credit event once the non-credit event has occurred. What is more, the uncertainty when and if the non-credit event has occurred is already captured by assigning a certain CCF to each of the guarantees, which represents an ex-ante assessment. If it were not an ex-ante assessment, but the CCF would be meant to be adjusted over the life of the instrument then the logic should be not to assign a CCF of 50% but of 0% and turn it into 100% once the non-credit related event has happened, which we do not propose.

Finally, it would operationally not be feasible. The guarantor will typically never be informed about the occurrence of the non-credit related event. Hence, he cannot change the category and will always be in violation of the regulatory law. The guarantor will also not be able to properly price the guarantee, as in case he finds out about the occurrence of the non-credit risk related event, he has to provide for more underlying. He typically has no or little experience nor data to predict even average times for the occurrence of such events.

In this context it is not clear which bucket is to be applied to guarantees which are only partly dependent on a non-credit risk related event. Take for example a typical rental guarantee, which can be drawn by the beneficiary not only when the property is not returned in a good state (non-credit risk related even) but also when the rental payments are due and not paid (credit risk related event). According to the wording of Annex I we would see this instrument in bucket 2 (performance bonds), as credit substitutes are only allocated to bucket 1 where they are not explicitly included in any other category.

We would like to seek clarification on the applicable bucket for commitments to issue trade finance balance sheet items. It seems contradictory that the commitment to issue such instruments bears a higher CCF as the instruments themselves.

According to the bucket 1 examples presented in the RTS, contingent items “where all relevant non-credit risk related conditions have been triggered that previously prevented exposing the institution to the risk of credit losses in case of default of the obligor, and the institution’s guarantee is only conditional on a default event for the guaranteed credit obligation” move to bucket 1 with a CCF of 100%.

In the case of documentary credits with deferred payment (payment usually 30, 60 or 90 days after presentation of the agreed documents), a narrow interpretation of the paragraph above could lead to a shift to bucket 1 because the presentation of the documents triggers the non-credit risk-related event.

We approve of the general direction to promote and facilitate trade finance by applying a CCF of 20%. However, the new implications of the RTS contradict this notion by penalizing documentary credits with deferred payment by moving them to bucket 1 with a CCF of 100% for a portion of their life span. The additional costs connected with the higher CCF will adversely affect trade finance, making it less attractive for banks and importers.

We therefore kindly ask for clarification that documentary credits, with or without deferred payment, should stay in bucket 2 for their entire duration.

Furthermore, we believe that the example under bucket 3 on undrawn amounts of factoring arrangements does not reflect the nature and specificities of the factoring business and its limits and hence, should be removed from the list.

Most factoring limits are provided on an uncommitted basis. This is still the case under the new definition of commitments, as the arrangements fulfil Art. 5 (10) a)–e) CRR 3. Hence these limits are out of the scope of CCF application.

But even if they were in scope, they would to be seen as UCCs and would be classified in bucket 5. Hence, there is no room to list this as an example in bucket 3.

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

NA

Question 3. What is the applicable percentage the institution currently apply to these commitments?

NA

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

NA

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

On Art. 1(2):

The EBA assigns off-balance sheet items a 50% CCF where the institution's exposure to the risk of credit losses in the event of default of the obligor is contingent to at least one non-credit risk related event that has yet to occur. We seek clarification that the performance of a service is not to be interpreted as credit risk related event. Otherwise, performance bonds would not meet the aforementioned condition and thus have to be assigned to bucket 1, which would contradict the level 1 text.

On Art. 1(3):

The EBA assigns items where the client must draw certain amounts in the future to bucket 1 and provides the examples of mortgage loan offers not yet accepted and forward starting loans (para. 16/17). In our view, this is only appropriate if the client can still draw post default. We suggest rephrase Art. 1(3) accordingly.

In our opinion, the customer is generally not obliged to have a specific loan amount paid out. Accordingly, we assume that unutilised commitments from loans for which there is no contractual obligation to draw down by the borrower do not have to be allocated to category 1. In the case of forward-starting loans, where the agreed conditions stipulate that the customer must draw down certain amounts at certain times, it is also common for the conditions to stipulate that drawdowns may only be made if it can be expected that the borrower will be able to fulfil the payment obligations. Thus, the timing of the drawdown is not at the debtor's discretion and the debtor's ability to drawdown is conditional on no default occurring. In other words: If the debtor defaults, it cannot be utilised. The institution is therefore only exposed to the debtor's default once the drawdown has taken place at the specified drawdown time.

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

In relation to the definition of 'unconditionally cancellable commitments' and the bucket 5, we would kindly ask the EBA to amend the term 'commitment the terms of […] that effectively provide for automatic cancellation due to a deterioration in a borrower's creditworthiness'. In our view, it is sufficient if the commitment contract includes a cancellation provision that the bank has the right to terminate the commitment if the borrower's creditworthiness deteriorates. In contrast, it is not mandatory that the contract includes provisions that the contract is automatically terminated in case the borrower's creditworthiness deteriorates.

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

The CRR 3 explicitly mandates EBA to specify factors that may constrain UCCs. However, the specifications of these factors should not lead to a significant gold plating, de-facto restricting the use of the 10% CCF foreseen in the level 1 text to very few or even no cases at all in practice and thus undermining the level 1 text. Instead the factors should be specified in a way that maintains the intention of the level 1 text and enables banks to actually assess them in a meaningful manner prior to default.

For example, Art. 2(b) appears to be inappropriately broad and in effect overly restrictive (commercial considerations aimed at avoiding negative impacts on the creditworthiness of obligor or litigation risks)

According to Art. 111 para. 2 lit. e in conjunction with. Annex I of the CRR, commitments that can be cancelled at any time are to be taken into account in future with a factor of 10% (instead of 0% as previously). The increase in this factor is due to a Basel requirement and was justified at the time by the fact that consumer protection laws, risk management capabilities and reputational risk considerations can restrict the ability of banks to terminate such commitments (BCBS consultative document, revisions to the standardised approach 2014).

In Art. 111 (8) (b), the EBA is requested to specify those factors that could restrict the ability of banks to terminate commitments that can be cancelled at any time. In this context, the EBA would like to propose in Art. 2 RTS-E essentially the factors already mentioned by the Basel Committee (deficiencies in risk management procedures (a), reputational risks (c) and risks of legal disputes (d)). Should an increase in the weighting factor be provided for commitments that can be cancelled at any time and that fulfil the above criteria, these factors would actually be taken into account twice.

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 communicated to EBA" listed in each bucket of Annex I?
- Do you identify any specific item you may hold off-balance sheet that is currently classified as "Other off-balance sheet items carrying similar risk and as communicated to EBA" and that may experience a change in bucket allocation based on the criteria listed in Article 1 of these RTS? What would be the related change in the associated percentage as per article 111(2)?

We were considering assigning a CCF of 20% to commercial guarantees with a maturity of more than one year (Medium/low risk). These would now fall within bucket 2 (CCF 50%).