Article 3

Off-Balance Sheet Items

This is a fairly technical part of the Basel Accords.

For those of you who are conversant with this class of exposures, I have summarised the Basel IV changes in the summary below.

For those of you who need an introduction to this risk class, the concepts and mechanisms involved are explained in more details in the "Concepts and scope of application" section.

Summary

1. Changes to the Standardised Approach

The main changes are the following:

A. A 40% CCF will apply to irrevocable undrawn commitments i.e. committed lines of credit that cannot be cancelled unilaterally (See below).

This treatment replaces the current treatment where irrevocable commitments with an original maturity up to one year and commitments with an original maturity over one year receive a CCF of 20% and 50%, respectively.

B. A 10% CCF will be applied to facilities that are unconditionally, unilaterally, cancellable by the bank.

The current CCF is 0%

This is an entirely new capital charge, which will apply to the tens of thousands of standard facility letters routinely issued by Standardised Banks.

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2. Alignment of the Standardised and IRB Approaches

The revised Standardised Approach treatment of off-balance sheet items is "exported", in its entirety, to the Foundation Approach and to most of the Advanced Approach.

A. Foundation Approach

- All the Standardised Approach CCF's will be used in the Foundation Approach.

Currently, the only difference between the Standardised and the Foundation Approach is the treatment of non-cancellable commitments, which receive a 75% CCF regardless of the maturity of the commitment.

Under Basel IV, the new 40% CCF replaces the 75% CCF and the treatment of off-balance sheet items in the two Approaches will thus become identical.

B. Advanced Approach

- Advanced IRB banks will have to use the Standardised Approach CCF's for their off-balance sheet exposures to **banks** (i.e. their FI business) and to **large corporates** (with a turnover in excess of € 500 million).

This is because Basel IV will no longer allow banks to use the Advanced Approach for their exposures to banks and large corporates. They will have to use the Foundation Approach, which uses the Standardised Approach CCF's as explained above.

- Even when the Advanced Approach is still allowed (E.g. for smaller corporates), banks will have to use the Standardised Approach CCF's for **all their off-balance sheet** exposures (E.g. letters of credit, performance bonds etc.) except for undrawn ***revolving*** commitments.

- Even these undrawn revolving commitments however are subject to a CCF, as Basel IV imposes a floor on the estimates of these off-balance sheet exposures, which is calculated by applying a CCF equal to 50% of the CCF that would be applicable in the Standardised Approach.

So, **undrawn revolving commitments** remain, to a very limited extent, the only off-balance sheet exposure for which Advanced banks can still use their own estimates of EAD.

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Concepts and Scope of Application

1. "Off-balance sheet" items as a risk class

The criterion on which this class of exposures is based is as old as it is unfortunate.

This is because being "off-balance sheet", in and of itself, has nothing to do with the risk inherent in an exposure.

The real reason why this category exists and receives a special credit risk treatment is that the amount of credit risk inherent in *some* off-balance sheet instruments or commitments is different from their nominal or "face" value.

Generally, that credit risk tends to be lower, even a fraction of the face value.

It is the nature of these instruments that requires the conversion of their nominal value into a "loan equivalent" through the use of percentages called credit conversion factors (CCF), not the fact that they happen to be "off-balance sheet".

This is why the successive Basel Accords, including Basel IV, have had to create a bizarre category of "100%" CCF's to deal with those off-balance sheet items that do carry a credit risk equal to that of a loan, and do not therefore require a specific treatment.

It is bizarre because a 100% Credit "Conversion" Factor does not of course convert anything and is nothing more than a contradiction in terms.

If this exposure class had been (properly) defined on the basis of the credit risks of the instruments rather than their location in the accounts, this 100% CCF category would not have existed.

1. What is a CCF?

In credit risk management the unit of reference is the loan, because the credit risk of loans is equal to the amount disbursed to the borrower, which is equal to the nominal amount or "face value" of the loan.

But if a bank extends an irrevocable 5-year term loan facility of 100 million, for which the borrower does not have an immediate need, the credit risk of the bank is not 100 million.

The risk is in fact somewhere between 0% and 100% of 100 million, depending on the future drawdowns, which are uncertain.

In the current Advanced IRB Approach, the bank itself will estimate its future drawdowns, based on its own history and knowledge of the transaction.

In the Standardised Approach the regulator does in effect the same, not of course on the basis of individual transactions, but by taking an industrywide view, across all banks, of the likelihood of drawdowns against committed facilities.

2. Mechanics

In the current Standardised Approach, this likelihood is estimated by the regulator as being 20% for undrawn irrevocable commitments of up to 1 year and 50% for undrawn irrevocable commitments of 1 year or more.

These percentages, which are often confused with risk weights because the amounts are similar, are called Credit Conversion Factors because they convert the nominal value of an instrument into a "loan equivalent" i.e. a loan that would carry the same risk as the instrument.

In the Standardised Approach, CCF's are applied to the exposure, in the IRB Approaches they are applied to the Exposure At Default (EAD).

So, to be perfectly clear, in the example of an undrawn commitment of, say, 5 years the regulator tells us that the credit risk of the 100 million exposure is in fact the same as the risk of a loan of 50 million. In other words the loan equivalent of the commitment is 50 million.

Assuming that the bank's minimum capital requirement is the Basel minimum of 8%, and the borrower is a corporate rated AA, the calculation of capital is as follows:

100 million x 8% x 20% (risk weight for AA rated corporates) x 50% (CCF) = 800,000.00

The same logic and process apply to the off-balance sheet items listed below.

3. Current treatment of off-balance sheet items

As mentioned in the summary, irrevocable commitments with an original maturity up to one year receive a CCF of 20% while commitments with an original maturity over one year receive a CCF of 50%.

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Apart from these commitments, the most common “off-balance sheet” instruments are the following:

- Transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions). CCF: 50%. This CCF remains unchanged under Basel IV.

- The issuing and confirming of short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralised by the underlying shipment) CCF: 20%. This CCF remains unchanged under Basel IV.

All the instruments above are in effect guarantees, albeit of different types, which the regulator deems to be, on the whole, less risky than loans. Documentary credits for example are deemed less risky because they are self-liquidating and collateralised.

These guarantees must not be confused with the guarantees of indebtedness, where a guarantor guarantees the payment of a debt (loan) to a creditor (lender) if the debtor (borrower) fails to pay.

It is worth mentioning because there is a common misconception that, because they are “off-balance sheet” (again!), these guarantees are a “smarter” or more “capital light” way of lending money.

It is wrong of course.

With this type of guarantee, the guarantor in effect takes the place of the lender, which is why these guarantees are called “credit substitution guarantees” or “credit substitutes” as the Basel Accords call them.

The credit risk of these guarantees, and of all “credit substitutes”, is identical to the credit risk of the debt (loan) they guarantee, and they therefore must be allocated exactly the same level of capital as loans.

And there is no need to convert them into a loan equivalent, particularly not with a 100% CCF like the Basel Accords insist on doing.

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Basel IV Changes

1. Changes to the Standardised Approach

As explained in the summary above, two new CCF's are created: a 40% CCF for committed lines of credit that cannot be cancelled unilaterally and a 10% CCF for the facilities that are unconditionally, unilaterally, cancellable by the bank.

The 40% CCF replaces the current treatment where irrevocable commitments with an original maturity up to one year and commitments with an original maturity over one year receive a CCF of 20% and 50%, respectively.

The 10% CCF is an entirely new capital charge, which will apply, as mentioned earlier, to the tens of thousands of standard facility letters routinely issued not only by Standardised and Foundation Approach banks but also to a large extent by Advanced Approach banks. (See 2 below).

This new charge aligns the Standardised banks (and the Foundation banks) with the Advanced Approach banks, which were the only ones under Basel II to allocate capital (through the EAD) to undrawn credit lines that could be cancelled unilaterally.

Note that the language used by the new rules to establish this new 10% capital charge is counter intuitive and even at odds with market practice: the terms "commitments" and "committed" suggest that a facility may *not* be cancelled unilaterally.

A "commitment fee", for example, is charged precisely because the lender waives the right to cancel payment i.e. undertakes to pay.

In this case, the Basel Committee has decided, in its wisdom, to assign a much wider meaning to "commitment":

"For these purposes, commitment means any contractual arrangement that has been offered by the bank and accepted by the client to extend credit, purchase assets or issue credit substitutes. ***It includes any such arrangement that can be unconditionally cancelled by the bank at any time without prior notice to the obligor***."

In other words, it is the acceptance of a facility letter, not the existence of a legal obligation to lend, which creates a commitment.

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2. Alignment of the Standardised and IRB Approaches

As explained in the summary above, all the Standardised Approach CCF's (for commitments and guarantees) are "exported" to the Foundation Approach and to most of the Advanced Approach.

The explanations provided in this section should make this summary accessible to all.

Assessment

Under Basel IV the CCF's applicable to transaction-related guarantees (Performance bonds, bid bonds, Standby L/C's etc.) and documentary credits (20%) will have to be used regardless of the Approach used by the bank.

This is a good thing. These "off balance sheet items" are banking products. Conservative estimates of EAD create a commercial disadvantage for prudent banks and aggressive estimates give reckless banks an unfair advantage.

The Basel Accords are meant to create a level-playing field, not to distort competition.

The harmonisation of the treatment of irrevocable commitments with a "middle of the road" CCF of 40 % applicable to (almost) all irrevocable commitments, on the other hand, makes sense.

The dual CCF (20%/50%) system of the Standardised Approach is a leftover from Basel I and is at odds with the 75% of the Foundation Approach, which was never supposed to be more conservative than the Standardised Approach.

The use of the 40% CCF's for bank commitments to banks and large corporates should restore the level playing field that used to exist in the syndication markets with the Basel I 50% CCF applicable to commitments of more than 1 year.

Why Basel IV did not go all the way and apply the CCF treatment to all irrevocable commitments, i.e. also to commitment to smaller corporates is unclear, particularly in view of the 50% floor that limits the estimates of EAD in any case.

Which finally leaves us with the new 10% CCF applicable to unconditionally cancellable commitments.

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This new charge makes Standardised banks the losers of these reforms, particularly those that, as is common practice, generously issue, free of charge, solicitation facility letters to prospective clients. They will have to be more parsimonious with their facility letters, or charge for them.

I hope they read this article.

Jean-Charles Pirlet
Director - Credit & Basel IV Services
jean-charles.pirlet@banktandd.com