Is a forward starting loan to be considered an off-balance item? If so, how should a conversion factor (CF) be assigned in accordance with Article 166 CRR?

Forward starting loans are loans that are signed in advance of a contractually agreed first possible day of utilisation. Prior to this date, the loan cannot be drawn and the institution cannot occur any credit losses if the borrower defaults. Since a forward starting loan is signed in advance of the first possible utilisation date, it is not clear whether this should be considered an off balance item and whether this depends on the time horizon. If a forward starting loan can be considered an off balance item, it is not clear how the CF should be applied prior to the first possible day of utilisation. In our view, in case the institution does not use own
estimates of LGD/CF, a product such as the forward starting loan would not directly match any of the categories mentioned in Article 166(1) to (8) or Annex 1 in CRR. However, it could, from a risk point of view, be comparable to a credit line characterised by Article 166(8)(a) or a low risk item as referred to in Article 166(10)(d) and Annex I CRR, as the terms of the facility effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness. This may be ensured through financial covenants embedded in such loan agreements. In case the institution uses own estimates of LGD and CF, following the above comparison to Article 166(8)(a), an own estimate, in line with the last alinea of Article 166(8), would reflect the capability and willingness of the institution to prevent further drawings, supported by a combination of empirical evidence, current policies and documentary protection (according to Article 182 CRR). However, if a forward starting loan falls within the scope of Article 166(10), own estimates are precluded, and the off-balance sheet item shall be assigned to the risk categories as indicated in Annex I.

EBA answer

If under the applicable accounting framework a forward starting loan, which has been granted by an institution and which can be drawn at any time after the contractually specified first utilisation date at discretion of the client, is considered as an off-balance sheet item until the credit facility is drawn in full, it will constitute a credit exposure within the scope of application of Article 111 CRR for institutions using the Standardised Approach (SA) and respectively Article 166 for institutions using the Internal Ratings Based (IRB) Approach.

For the purpose of determining the appropriate conversion factor for the undrawn exposure, in accordance with Article 166(8) and the risk categories in Annex I of the CRR as referred to by Article 166(10), institutions should analyse the terms and conditions as well as internal procedures for possible cancellations. For this purpose it is necessary to separately assess the period during which the credit facility cannot be drawn and the period during which the credit facility can be drawn, as terms and revocability conditions may differ. However, the circumstance that a credit facility cannot yet be drawn is not directly relevant for the purpose of calculating the exposure value.

Under the IRB approach, as clarified in Q&A 1263, Q&A 2397 and Q&A 2663, an institution shall calculate the exposure value of its undrawn exposures according to Article 166(8) to (10) CRR.

When the terms of the facility and institutions' policies allow the institution to cancel the facility unconditionally at any time without notice or effectively provide for automatic cancellation due to deterioration in the borrower's credit worthiness before the date from which the committed amount can be drawn, such that the client does not have the discretion to
draw down the facility at any time in the future, the following applies:

- where the institution does not have permission to use own estimates of LGD and conversion factors, the conversion factors specified in Article 166(8) CRR apply; a conversion factor of 0% may apply if the conditions in Article 166(8)(a) CRR are met;

- where the institution has permission to use own estimates of LGD and conversion factors for the product types mentioned in Article 166(8)(a)-(d) CRR, own estimates of conversion factors apply;

- for all off-balance sheet items other than those mentioned in paragraphs (1) to (8) of Article 166 CRR, paragraph (10) of that Article applies; the off-balance sheet item may be assigned to the low risk category if the conditions in point (4) of Annex I CRR are met.

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