

# Single Rulebook Q&A

<b>Question ID</b>	2018_3918
<b>Status</b>	Final Q&A
<b>Legal act</b>	Regulation (EU) No 575/2013 (CRR)
<b>Topic</b>	Credit risk
<b>Article</b>	166
<b>Paragraph</b>	10
<b>Subparagraph</b>	c
<b>COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations</b>	Not applicable
<b>Article/Paragraph</b>	Not applicable
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<b>Disclose name of institution / entity</b>	Yes
<b>Name of institution / submitter</b>	BaFin
<b>Country of incorporation / residence</b>	Germany
<b>Type of submitter</b>	Competent authority
<b>Subject matter</b>	Classification of a commitment to make under certain conditions an indemnity payment for a customer
<b>Question</b>	<p>Does a commitment to make under certain conditions an indemnity payment on behalf of a customer constitute an “off-balance sheet item other than those mentioned in (Article 166) paragraphs 1 to 8” according to Article 166(10) CRR?</p> <p>If so, does it constitute a medium/ low risk item according to Article 166(10)(c) CRR, specifically as one of the “other items also carrying medium/low risk and as communicated to EBA” according to Annex I, No. 3(b)(ii) CRR?</p>
<b>Background on the question</b>	An institution commits to pay (up to) a certain amount to a third party, if both the following conditions are met: 1. a predefined event occurs that forces the institution’s customer to make an indemnity payment to a third

party and 2. the institution's customer fails to meet its payment obligation to the third party (after the trigger event has arisen). With regard to Article 166(8) CRR, Q&A 2663 highlighted in particular: "When a "credit line" (or a note issuance facility or a revolving underwriting facility) cannot be subsumed under one of the more specific definitions in letters (a), (b) or (c), it shall be treated under letter (d). In this context "other credit lines" will entail all credit lines other than unconditionally cancellable credit lines described under letter (a)." In line with the question posed by the submitter it however listed only two specific types for off balance sheet items that must be treated under Article 166(10) CRR: (long term) letters of credit or guarantees for the good payment of credit facilities. This question is about clarifying the treatment for further types of off balance sheet items. Examples for the type of commitments that are in focus here include: The institution's customer is a building contractor. According to legal requirements the latter is obliged to warrant for the quality of his work for a certain period of time (usually a couple of years). The institution commits to the owner of the building to pay an indemnity on behalf of the building contractor if deficiencies are not removed and the latter fails to honour his commitment to the owner. The institution's customer is a tenant. He commits to his landlord to pay him a certain indemnity, e.g. in case the tenant fails to return the flat in the agreed good state. The institution commits to the landlord to pay the indemnity on behalf of the tenant, should the tenant fail to honour his commitment to the landlord.

**EBA answer**

Where an institution guarantees a customer's obligation to make an indemnity payment to a third party and this guarantee is - as set out in the background of the question - conditional on both

1. an event triggering the obligation for the institution's customer to pay an indemnity to the third party and
2. the institution's customer failing to make the payment of such an indemnity

there can be different scenarios, which impact on the classification on the assignment of such off-balance sheet item to one of the risk categories in Annex I CRR, as required for the purposes of Article 166(10) CRR. In particular, the classification depends on the purpose of the customer's indemnity payment obligation and on whether the customer's indemnity payment obligation has already been triggered under the customer's contract.

In case the first condition is met (i.e. the predefined event occurs), the guarantee is to be considered a full risk item in accordance to point 1(a) of Annex I CRR, as in such case the guarantee would be for the good payment of the triggered payment obligation of the customer to the third party, which would have the character of credit substitutes.

The same applies in case the first condition is not met, to the extent that the

	<p>customer's indemnity payment obligation serves as protection for a credit risk exposure to a third party different from the customer, because in this case the institution provides a counter-guarantee for the customer's payment obligation, under a guarantee for the credit risk exposure to the third party.</p> <p>In contrast, in case the first condition is not met and the un-triggered indemnity payment obligation serves for providing compensation for the customer's failure to perform under a contract that is not related to credit risk - such as the obligations of a building contractor or a tenant described in the background on the question - the institution's guarantee for the customer's indemnity payment obligation does not (yet) expose the institution in full to the credit risk of the customer and therefore does not have the character of a credit substitute. The assignment to one of the non-full risk categories in Annex I CRR therefore depends on whether the additional qualifying criteria set out therein are met.</p> <p>In particular, where the institution provides a guarantee for the customer's indemnity payment obligation, this scenario does not qualify as an undrawn credit facility for performance guarantees, and cannot qualify as low risk item. On the other hand, for warranties (in particular performance bonds) or other guarantees not having the character of credit substitutes to classify as medium/low risk paragraph (3)(a)(ii) of Annex I CRR requires them to be trade finance off-balance sheet items.</p> <p>For this reason, unless they are undrawn credit facilities or trade finance off-balance sheet items or fit a different, more specific categorisation, the classification for the described guarantees could be as:</p> <ul style="list-style-type: none"> <li>• medium risk item, specifically as other items also carrying medium risk and as communicated to EBA, set out in paragraph (2)(b)(iv) of Annex I CRR; or as</li> <li>• medium-low risk item, specifically as other items also carrying medium/low risk and as communicated to EBA, set out in paragraph 3(b)(ii).</li> </ul>
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