

## **EIC Position on Proposed Revision of the EU Capital Requirements Regulation**

COM (2021) 664 final

(27 June 2022)

**EIC calls upon the EU legislator to maintain the Credit Conversion Factor (CCF) for Technical Guarantees at 20% in order prevent further rises in construction prices and to preserve the competitiveness of European exporters**

### **Policy background**

The European Commission has submitted on 27 October 2021 to EU co-legislators a proposal for amendment of Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor (COM(2021) 664).<sup>1</sup> This revision of the Capital Requirements Regulation (CRR) makes part of a banking package that aims at fully implementing the Basel 3 Accord, including the final set of reforms agreed by the Basel Committee in December 2017, taking into account the specific features of the EU banking sector. It further has the ambition to strengthen the resilience of the banking sector to environmental, social and governance (ESG) risks and to provide stronger tools for supervisors overseeing EU banks.

The proposed revision of the CRR brings changes to the credit risk capital estimation methods, amongst others regarding the off-balance sheet exposures - among which are technical guarantees such as bid and performance bonds - and specialised lending exposures -, among which is project finance lending - which are specifically relevant for European international contractors and also infrastructure investors. The challenge is to strengthen the resilience of the banking system without resulting in unnecessary increases in capital requirements that would result in higher financing costs and conditions penalising the European economy in challenging times. The final rules must not lead to a general increase of capital requirements across the board and need to ensure a level playing field between EU banks and foreign banks regulated under third country law.

### **About EIC**

European International Contractors (EIC) is a European industry federation with the mandate to promote the interests of the European construction industry in relation to its *international* business activities. EIC has as its members national construction associations from fifteen European countries to which internationally active European contractors are affiliated as well as associated member companies from construction-related industries and professions. In 2020, the total volume of international turnover carried out by internationally active construction companies associated with the fifteen EIC Member Federations amounted to more than US\$ 230 billion (ENR Statistics).

<sup>1</sup> [EUR-Lex - 52021PC0664 \(europa.eu\)](https://eur-lex.europa.eu/eli/reg/2021/664/01)



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## EIC Observations

### Increase in the CCF for Technical Guarantees from 20% to 50% (Art. 111 and Annex 1)

The EU Commission proposes to amend the classification and the corresponding Credit Conversion Factors (CCF) applicable to off-balance sheet exposures in Article 111.2 and Annex 1. As a result, Technical Guarantees such as bid and performance bonds, previously classified as “medium/low risk” with a corresponding CCF of 20%, would henceforth pertain to bucket 2, assorted with a CCF of 50%.

This is excessively penalising for construction companies which are required by their public and private clients to provide bid and performance bonds for tendering for and executing construction projects. The issuance by banks of such technical guarantees is done at the risk and expense of construction companies, being a commercial necessity to participate in the competition without an immediate benefit for them.

If the proposal of the EU Commission were approved, it could lead to a cost increase of up to 150% and/or a reduced capacity by banks, without being justified by empirical evidence, since analysis by the International Chamber of Commerce (ICC) and Global Credit Data (GCD) on a dataset of defaulted bank customers with performance guarantees facilities between 2000 - 2018 reveals that the empirical average CCF (paid/ issued at facility level) amounts to 14% for bid and performance bonds and 10% for performance guarantees in general.<sup>2</sup>

**Therefore, EIC holds that the currently applied CCF of 20% is adequate.** Moreover, the 2021 ICC Trade Register data shows that the obligor weighted default rate of performance guarantees is below of 0.5 %.<sup>3</sup>

Financial conditions, and trade finance conditions in particular, are a major factor of the competitiveness of companies in the construction industry. In this area, the differences in the regulatory framework between the EU and the rest of the world may be very detrimental to the level playing field between European international contractors and their third-country competitors.

Typically, the amount of Performance Bonds is set to 10% or more of the value of the project. Technical Guarantees can represent over 1% of total price, depending on several factors, including price, duration of the contract from bid to end of the warranty period and taxes.

Under normal market conditions, the extra costs resulting from the increased CCF will impact the construction price. European international contractors will either have to increase their prices - to the detriment of their competitiveness - or reduce their margins, which are already under stress due to persisting tensions in the supply chains.

**Therefore, EIC recommends maintaining Technical Guarantees (“Performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions and similar transaction-related contingent items”) in the medium/low risk class** which corresponds to the bucket 4 of the new Classification of off-balance sheet items provided in the Annex to the Proposal.

<sup>2</sup> [ICC/GCD 2022 Performance Guarantees Paper](#), April 2022

<sup>3</sup> [2021 ICC Trade Register report: Global risks in trade finance](#)



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## Project finance (Art. 495b)

Furthermore, EIC as well as FIEC have joined forces with the European Banking Federation (EBF) in scrutinising the provisions of concern for contractors in the proposed revision of the Capital Requirements Regulation. Among the amendments recommended by EBF, those related to the phase-in and calibration of the new loss-given default (LGD) input floors applicable to specialised lending (SL) exposures treated under the internal risk-based approaches (IRBA), see Article 495b, are particularly relevant for European international contractors, and consequently supported by EIC in the Annex.

The introduction of the new class of SL exposures is in line with the Basel III standards. Among SL classes, Project Finance is of particular importance for the construction industry and is bound to play an even more important role in the years to come. It is satisfying to see that the present proposal acknowledges on the one hand that the promotion of infrastructure projects is of vital importance for the economic growth of the European Union, and on the other hand that specialised lending by banking institutions is a defining characteristic of the EU economy, as compared with other parts of the world where such projects are predominantly financed by capital markets.

EIC concurs with EBF that it is appropriate to provide for a transitional period during which the LGD input floor applicable to SL exposures treated under the IRBA is reduced, but lower factors and a longer transition period would better ensure that SL transactions (infrastructure transactions notably) are not overly penalised by the LGD input floors, until the European Banking Authority (EBA) publishes its report on the calibration of risk parameters and appropriate corresponding new regulatory standards are defined.



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# Annex

to

## **EIC Position Paper**

on

### **Proposed Revision of the EU Capital Requirements Regulation**

## Suggested Amendments

(27 June 2022)

## Amendment 1

### Proposal for a regulation Annex – table

<i>Text proposed by the Commission</i>	
Bucket	Items
1	<ul style="list-style-type: none"> <li>• General guarantees of indebtedness, including standby letters of credit serving as financial guarantees for loans and securities, and acceptances, including endorsements with the character of acceptances, as well as [any] other direct credit substitutes;</li> <li>• Sale and repurchase agreements and asset sales with recourse where the credit risk remains with the institution;</li> <li>• Securities lent by the institution or securities posted by the institution as collateral, including instances where these arise out of repo-style transactions;</li> <li>• Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawdown;</li> <li>• Off-balance sheet items constituting a credit substitute where not explicitly included in any other category.</li> <li>• Other off-balance sheet items carrying similar risk and as communicated to EBA.</li> </ul>
2	<ul style="list-style-type: none"> <li>• Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) regardless of the maturity of the underlying facility;</li> <li>• <b><i>Performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions and similar transaction-related contingent items;</i></b></li> <li>• <b><i>Off-balance sheet items not constituting a credit substitute where not explicitly included in any other category.</i></b></li> <li>• Other off-balance sheet items carrying similar risk, as communicated to EBA.</li> </ul>
3	<ul style="list-style-type: none"> <li>• Commitments, regardless of the maturity of the underlying facility, unless they fall under another category;</li> <li>• Other off-balance sheet items carrying similar risk, as communicated to EBA.</li> </ul>
4	<ul style="list-style-type: none"> <li>• Short-term, self-liquidating trade letters of credit arising from the movement of goods, in particular documentary credits collateralised by the underlying shipment, in case of an issuing institution or a confirming institution;</li> <li>• Other off-balance sheet items carrying similar risk, as communicated to EBA.</li> </ul>
5	<ul style="list-style-type: none"> <li>• Unconditionally cancellable commitments;</li> <li>• The undrawn amount of retail credit lines for which the terms permit the institution to cancel them to the full extent allowable under consumer protection and related legislation;</li> <li>• Undrawn credit facilities for tender and performance guarantees which may be cancelled unconditionally at any time without prior notice, or that do effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness;</li> <li>• Other off-balance sheet items carrying similar risk, as communicated to EBA.</li> </ul>

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Or. en

#### *Justification*

*Technical guarantees such as performance bonds and bid bonds are currently classified as 'Medium/low risk' with a corresponding CCF of 20%. The new classification proposed by the Commission would put them in bucket 2 of the Annex 'Classification of Off-Balance Sheet Items', assorted with a CCF of 50%. This is excessively penalising for contractors which are required to provide bid and performance bonds for public and private project, as it could lead to a cost increase of up to 150%, and/or a reduced capacity by banks, without being justified by empirical evidence.*

## Amendment 2

### Proposal for a regulation

#### Article 1 – paragraph 1 – point 199

Regulation (EU) No 575/2013

Article 495b – paragraph 1

#### *Text proposed by the Commission*

1. By way of derogation from Article 161(4), the LGD input floors applicable to specialised lending exposures treated under the IRB Approach where own estimates of LGDs are used, shall be the applicable LGD input floors provided for in Article 161(4), multiplied by the following factors:

- (a) **50** % during the period from 1 January 2025 to 31 December **2027**;
- (b) **80** % during the period from 1 January **2028** to 31 December **2028**;
- (c) **100** % during the period from 1 January **2029** to 31 December **2029**.

#### *Amendment*

1. By way of derogation from Article 161(4), the LGD input floors applicable to specialised lending exposures treated under the IRB Approach where own estimates of LGDs are used, shall be the applicable LGD input floors provided for in Article 161(4), multiplied by the following factors:

- (a) **30** % during the period from 1 January 2025 to 31 December **2028**;
- (b) **70** % during the period from 1 January **2029** to 31 December **2030**;
- (c) **80** % during the period from 1 January **2031**.

Or. en

#### *Justification*

*The objective of this amendment is to make sure that SL transactions (infrastructure transactions notably) are not overly penalized by the LGD input floors until the EBA publishes its report.*

## Amendment 3

### Proposal for a regulation

#### Article 1 – paragraph 1 – point 199

Regulation (EU) No 575/2013

Article 495b – paragraph 2

#### *Text proposed by the Commission*

2. EBA shall prepare a report on the appropriate calibration of **risk parameters** applicable to specialised lending exposures under the IRB Approach, **and in particular on own estimates of LGD and LGD input floors**. EBA shall in particular include in its report data on **average** numbers of defaults and realised losses observed in the Union for different samples of institutions with different business and risk profiles.

EBA shall submit the report on its findings to the European Parliament, to the Council, and to the Commission, by 31 December 2025.

On the basis of that report, the Commission shall be empowered to amend this Regulation by adopting a delegated act, where appropriate, in accordance with Article 462, to amend the treatment applicable to specialised lending exposures under Part Three, Title II.;

#### *Amendment*

2. EBA shall prepare a report on the appropriate calibration of **final LGD input floors, including the haircut parameter**, applicable to specialised lending exposures under the IRB Approach, **in order not to penalize high quality transactions**. EBA shall in particular include in its report **detailed** data on numbers of defaults and realised losses observed in the Union for different samples of institutions with different business and risk profiles, **and also an assessment of the impact of the applicable regulation and guidelines, on the financing of underlying economic activities financed by SLEs**.

EBA shall submit the report on its findings to the European Parliament, to the Council, and to the Commission, by 31 December 2025.

On the basis of that report, the Commission shall be empowered to amend this Regulation by adopting a delegated act, where appropriate, in accordance with Article 462, to amend the treatment applicable to specialised lending exposures under Part Three, Title II.‘.

Or. en

#### *Justification*

*In its report “Policy Advice on the Basel III Reforms: Credit Risk” (Aug. 2019), §361, the EBA stated that Specialized Lending transactions should be recognized as secured transactions for the purpose of LGD input floor determination. In that context, LGD input floor applied to an SL transaction should be strictly lower than the Corporate one (e.g. 25%).*

*In that context, EBA shall review the calibration of the LGD input floors and the Commission shall adopt a delegated act.*

*As a prerequisite, a deep analysis of detailed data on defaulted transactions will be needed in order for the EBA to review input floors levels. It is worth noting that the input floors should not be set at the level of average losses. Otherwise, high quality transactions, i.e. with low or no losses, would be highly penalized. We remind that 50% of project finance transactions got an LGD lower than 10% (S&P studies).*



## Amendment 4

### Proposal for a regulation

#### Article 1 – paragraph 1 – point 199

Regulation (EU) No 575/2013

Article 495b – paragraph 3 (new)

*Text proposed by the Commission*

*Amendment*

**3. EBA shall develop draft regulatory technical standards regarding the development of internal models of PD and LGD for specialized lending asset class under the IRB approach, taking into account the risk profile of the transactions and the specificities of Low Default Portfolios. EBA shall submit those draft regulatory technical standards to the Commission by [one year after the entry in force of this Regulation]. Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010.’;**

Or. en

#### *Justification*

*Current EBA Guidelines on PD and LGD estimations were drafted for High Default Portfolios. Many requirements set by the EBA in these Guidelines are not designed for Low Default Portfolios (such as SL transactions). Therefore, SL transactions are very much penalized. For example, the discount rate indicated in current EBA Guidelines,  $x_{bor} + 500$  bp results in a discount rate which is roughly twice higher or even more than the SL loans margins, thus resulting in artificial losses even when there is a full repayment by the borrower and full payment of interests. This creates a bias in the appreciation of the risk of loss of these activities, with overstated losses actually not born by the institutions. LDP portfolios would deserve adequate modelling rules not penalising low risk transactions.*