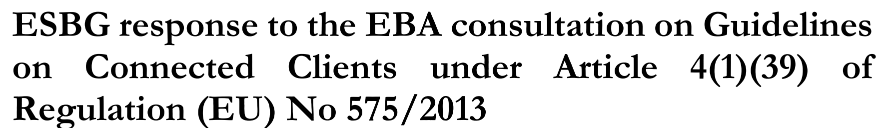
POSITION PAPER



ESBG response to the EBA consultation on Guidelines on Connected Clients under Article 4(1)(39) of Regulation (EU) No 575/2013

ESBG (European Savings and Retail Banking Group)

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Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA consultation *on Guidelines on Connected Clients under Article 4(1)(39) of Regulation (EU) No 575/2013*. We would like to share with you the following reflections that we hope will be taken into account by the EBA.

General comments

The new definition of economic dependency will lead to substantial changes, particularly to expansions regarding the classification of groups of connected clients within institutions. It would involve significant operational effort by banks as the number of groups of connected clients may increase substantially as well as the complexity of the groups as such.

A broader application of "economic dependency" would involve significant operational and IT efforts by banks which will have to adjust and change their procedures substantially (collection of information, definition of new rules, interconnection with other areas that use the concept of connected clients, validation, etc.) and IT systems. A transitional period should be envisaged by the present Guidelines to accommodate those changes since the proposed concept means an extensive enlargement compared to the existing CEBS Guidelines.

From a practical point of view, ESBG understands that lots of individually-arbitrary decisions have to be made in regard to the classification of a group of connected clients. To make these decisions, in practice, however, it may be difficult to obtain the required information, which is often not available even from current customer relationships. At this point, not only does the question arise of how the information procurement should be achieved, but also how could these administrative burdens be carried by the relationship managers, whose main mission is to serve clients.

Generally speaking, although we agree with the rationale of the approach focused on grouping connected clients in function of the existence of a "single risk" between clients regardless of the type of connection the single risk is based upon, ESBG is concerned with the inherent difficulties in identifying the exhaustive list of relationships based on economic dependencies, particularly in large groups (based on control) with a huge amount of economic interactions with other undertakings (with no control relationship) where economic dependencies could arise.

In accordance with the purpose, when establishing a group of connected clients, only the clients which are assessed to constitute a single risk should form a group of connected clients. Thus, when assessing interconnectedness based on control relationship and/or economic dependency, actual substantiality and material impact on credit risk in the individual case is to be considered.

Paragraph 25 of Section 3 (Background and Rationale) of the Consultation Paper states "[…] to identify channels of contagion stemming from economic dependencies that a client cannot overcome without experiencing repayment difficulties. However, even if a client is dependent on another client through, for instance, a business relationship, it could still be possible for the client to find a replacement for this business partner (in case of his default) […] This may cause practical problems, […] but if an institution comes to the conclusion that it would not lead to repayment difficulties, there is no requirement to consider such clients to be interconnected." We still find practical difficulties, such as finding a way to identify the frontier where such economic dependencies would lead to repayment difficulties as far as the scenario of "repayment difficulties" could depend on the decisions made by shareholders and managers in the case of default of the business partner (for example, injecting or not more funds into the company to re-adapt to the new scenario). Clarification would be much appreciated.

Furthermore, ESBG does not support tying economic dependency to the existence of general financial difficulties irrespective of their duration and how serious their consequences are for the lending institution.

Although the EBA recognises in paragraph 33 of Section 3 the inherent difficulties of identifying economic connections and (only) recommends that institutions increase their efforts to identify such economic connections for all exposures that reach an exposure value equal or above 2% of eligible capital, in the draft Guidelines (paragraph 35) the EBA states that "[…] institutions should intensively investigate potential economic connections for at least the exposures with an exposure value equal or above 2% of eligible capital." Hence, in the Guidelines the difficulties of investigating economic dependencies do not seem to be recognised. Furthermore, ESBG considers that this investigation is particularly difficult for large economic groups and for the stock of exposures a bank has. We consider it could be more reasonable (although the difficulties still arise) if the Guidelines could be progressively implemented with new concessions or renovations. However, we still invite the EBA to consider recognising such inherent difficulties through a new redaction of paragraph 35.

In addition, "repayment difficulties" could be to some extent a vague concept. In case of default of the business partner, the client can experience some practical problems that could be solved without entering into default, but that would imply financing needs to carry out the necessary measures to avoid a default situation without affecting the viability of the project. Should this be considered as repayment difficulties? Or if the client asked for new conditions for the payment of its debt and more easily adapt to the new scenario, but these new conditions would not imply a de facto refinancing, should this be considered as a repayment difficulty?

Besides the operational complexity of the proposed assessment which would require an additional and burdensome investigation of economic relations, we are particularly concerned about this *de facto* additional large exposure requirement, which seems unduly penalising. ESBG deems that the EBA should be aligned with the CRR purposes and that some specification should be introduced in the Guidelines to clarify that no duplication of exposures should be made for the large exposure rule.

It will be very challenging both conceptually and technically to connect only part (e.g. one single entity) of another group of connected clients to the other group of connected clients' single entity because when forming a single risk the credit assessment is typically assessed by the interconnectedness of the groups' financial robustness due to potential parent's implicit or explicit support or collateral arrangements. This could create a situation where the same single entity will de facto need to be managed outside its natural controlling group and then again within its natural controlling group and hence causing double counting of credit risk and unnecessary credit risk assessment.

The presentation of the examples in the consultation paper is very helpful and very much appreciated. However, from a practical perspective, the implementation of the examples E 2, E 3, E 6 (pages 17/18) and C/E 1-3 (pages 19-22) will be very difficult to implement and connections between e.g. different retailers and wholesalers or supply chains in different business sectors will hardly be identifiable.

We note in example E 2 presented in section 3.2.3, the variation to the main case (no direct exposure to source of risk), that the costs of identifying connections with customers with whom no customer relationship already exists is highly likely to surpass the expected benefits of these provisions. It will be a manual task to identify such a group where the relation is dependent on a customer to whom the institute has no exposure and limited knowledge about them. The identification process will be very burdensome and will rely on subjectivity. In case institutions manage to identify such customers how should that information be applied as information on such a customer is in most cases very limited and not necessarily providing an accurate picture of this customer. A proper identification process therefore can only be

bottom up, which makes it operationally complex. We also notice the burden stemming from the fact that such manually collected information needs to be manually updated regularly.

Furthermore, clarification would be appreciated whether paragraph 36 (page 23) refers to the example provided in E 2 (page 14) as well.

Finally, the consultation paper introduces also for central governments that banks have counterparties mapped in more than one group, which would lead to an unjustified multiple counting of banks' exposures.

<u>Question 1</u>: Are you aware of any situations where the existence of a control relationship among clients does not lead to a 'single risk'?

Yes, in every case where the financing is a ring-fenced structure that does not impact any related entity. Typical examples are project financing.

Similarly, every situation where a controlling entity makes it explicit that it does not exercise its formal control rights and there is no risk of default contagion, does not constitute a single risk from a counterparty credit risk management perspective.

Furthermore, this might be the case in situations where another party has such control as described in paragraph 13c (page 31), e.g. management rights based on contractual conditions, clauses, etc. Such types of control do not necessarily have an impact on financial difficulties, etc.

<u>Question 2</u>: What is the likely impact of the clarification of having an exceptional case when the existence of a control relationship does not lead to a 'single risk'? Please provide an estimation of the associated quantitative costs.

The impact is positive. It permits more accurate counterparty credit risk underwriting and steering by not mixing cash flows that should not be related.

<u>Question 3</u>: Do you see a need for further clarification of the accounting provisions which are relevant for large exposures purposes? If yes, please point out the exact indicator of control according to the Directive 2013/34/EU or Regulation (EC) No 1606/2002 which should be clarified with respect to the large exposures regime.

No.

<u>Question 4</u>: Are there any other indicators of control in the case of a similar relationship which are useful to add to this list of indicators?

No.

<u>Question 5</u>: What would be the cost of the assessment of the existence of control relationships in the case of subsidiaries exempted from accounting consolidation? Please provide an estimation of quantitative costs. In your experience, how significant are these cases?

It is our assessment that this is not a significant issue. Given the requirements for internal controls and procedures in general to identify individual customers for grouping, there are barely any significant additional costs either, in ESBG's view.

***Question 6*: Is the guidance provided in section 5. 'Alternative approach for exposures to central governments' clear? If not, please provide concrete suggestions.**

Yes, as long as there are no conditions in the regulations in order to apply this alternative approach and, above all, as long as the actual exemption for exposures to central governments is maintained pursuant to Art 400(1) CRR. The outlined structures determine multiple counting of risk positions to both central governments and controlled entities, since they can be included in different groups of connected clients.

***Question 7*: What is the likely impact of considering that clients are connected as soon as the failure of a client would lead to 'repayment difficulties' of another client? Please provide an estimation of any associated quantitative costs.**

First of all, ESBG would like to stress that when repayment difficulties are assessed the materiality of the impact on the level of credit risk for the bank as a result of the repayment problem should be taken into consideration.

Also, since the identification and grouping based on economic dependency is typically manual, the new and stricter formulation will increase the manual routines in order to identify "groups of connected clients" based on economic dependency.

We consider that the concept of "repayment difficulties" is to some extent a vague concept that would even make it more difficult for institutions to identify and delimit to what extent the economic dependencies would lead to contagion effect chains. A broader definition of entities constituting groups of connected clients would determine greater volatility in the composition of groups, with unintended effects in terms of operating costs and impact on credit risk management practices.

In any case, a more precise definition of "repayment difficulties" would help in order to specify that client likeliness to repay should be seriously impaired and lead to the event of default of the counterparty. ESBG therefore invites the EBA to maintain the existing reference to substantial, existence-threatening repayment difficulties (although we took good note of the EBA justifying in paragraph 23 of Section 3 the reason why the term of the 2009 CEBS Guidelines "substantial, existence-threatening repayment difficulties" is proposed to be replaced). Switching from the restrictive concept of 'default contagion' ("substantial existence-threatening repayment difficulties") to the less restrictive concept of 'repayment difficulties' is counterproductive and effectively prevents proper counterparty risk assessment and risk steering. By removing the crucial qualification that economic dependence exists only in case of 'default contagion', entire value chains may or must be connected. This creates artificial groupings that cannot be managed with the tools of counterparty credit risk management any more (financial analysis, counterparty rating…) and significantly deteriorates the quality of credit risk management in a bank. In ESBG's opinion, the further clarification provided by paragraphs 24 and 25 (page 16) does not remove this fundamental problem of the proposed modification to the current definition.

What is more, we generally doubt whether individual loan officers and relationship managers have the soft information needed to identify connected clients according to the new guideline (paragraph 34, page

23). To fulfil these extended requirements, banks could be forced to take additional external data providers to closely monitor their business relationships of the clients.

Economic dependence is an extremely important criterion for determining single risks that, by its very nature, can and should only be established based on a thorough case-by-case assessment. Except for point k), any of the criteria listed in paragraph 23 (page 35) may indicate economic dependence, but does not conclusively define it. The case-by-case assessment must be conducted by adequately skilled professionals familiar with the individual case. Defining any list of criteria may – and in practice does – lead to situations where the formation of a group of connected clients is done algorithmically by IT processes or by back-office functions not familiar with the particular case. This creates groupings that may not constitute a single risk, which undermines the very concept and usefulness of a group of connected clients.

***Question 9*: Are you aware of any other situations that should be added to the list of situations that constitute economic dependency? In relation to the situation described above, would you treat these exposures as connected? Please explain.**

No.

In relation to the case explained by the EBA, the financial difficulties of the guarantor would not imply financial difficulties for the unrelated clients, in ESBG'S opinion, unless an economic dependency exists between the guarantor and the clients that could be analysed with the guidelines provided in paragraph 23. The same applies to potential effects between the unrelated clients that are guaranteed by the same guarantor.

As a matter of fact, in our experience, this is quite an exceptional case. As the likelihood of simultaneous claims under guarantees to unrelated counterparties seems to be fairly low, ESBG would not qualify such clients as connected. The situation described in the explanatory box on page 35 would be an exaggerated interpretation of the term "single risk".

***Question 10*: Is the guidance in section 7. 'Relation between interconnectedness through control and interconnectedness through economic dependency' clear? If not, please provide concrete suggestions. What is the likely impact of this guidance? Please provide an estimation of the associated quantitative costs.**

Generally speaking, the relation between interconnectedness through control and interconnectedness through economic dependency will be difficult to assess as the approach foreseen requires different steps that have to be taken.

Moreover, the implementation of the envisaged measures is likely to determine in many cases multiple counting of risk positions to clients that should be included in different groups of connected clients. As stated before (please see the answer to question 6), we deem that double counting of exposures (due to entities being included in different groups of connected clients) is not desirable. In fact, this would lead to the double counting of the bank exposure to the client in the bank records aimed at supervisory reporting. Consequently (unless the bank creates a double-track management system detaching the credit risk management from supervisory evidences), the double counting would affect the monitoring of bank exposure to the client for risk management purposes, in terms of determining credit limits and allocating credit decisions.

About ESBG (European Savings and Retail Banking Group)

ESBG brings together nearly 1000 savings and retail banks in 20 European countries that believe in a common identity for European policies. ESBG members represent one of the largest European retail banking networks, comprising one-third of the retail banking market in Europe, with 190 million customers, more than 60,000 outlets, total assets of €7.1 trillion, non-bank deposits of €3.5 trillion, and non-bank loans of €3.7 trillion. ESBG members come together to agree on and promote common positions on relevant regulatory or supervisory matters.

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