

**British Bankers’ Association response to the EBA consultation on guidelines on Connected Clients under Article 4 (1) (39) of Regulation (EU) No 575/2013**

*24th of October 2016*

The BBA is the leading association for UK banking and financial services representing members on the full range of UK and international banking issues. It has over 200 banking members active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. Eighty per cent of global systemically important banks are members of the BBA.

As the representative of the world’s largest international banking cluster the BBA is the voice of UK banking.

All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management.

Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

We welcome the opportunity to respond to European Banking Authority’s (EBA) consultation on guidelines on Connected Clients under Article 4 (1) (39) of Regulation (EU) No 575/2013[[1]](#footnote-1).

The BBA has considered the consultation document and subsequent questions and has obtained further input from a number of its members. We would like to open by acknowledging that monitoring and reporting of Large Exposures for connected clients are an important element of the overall regulatory ecosystem for banks operating in UK. As such, changes proposed in EBA’s CP 2016/09 represent a change to how banks operating in Britain interact with regulators and monitor large exposures/risk of interconnectedness.

**Overall observations and recommendations**

Overall we found the proposed change in treatment would require:

* Further clarity on Economic groups and Funding groups reporting;
* Further confirmations of focus on analyst judgement when choosing to aggregate entities (or not), especially in case of economic or funding groups;
* Focus of the guidance on a principle based approach to aggregation, rather than following a prescriptive approach, where the following become key:
  + Identification of material links between entities,
  + Clear and direct cash transfers between the entities,
  + Direct material risk of default of the grouping if failure occurs at one of the aggregated entities,
  + Confirmation that the proposed triggers (including any ownership or economic link materiality thresholds) become triggers for considering, rather than mandating, aggregation;
* Clear delineation of Large Exposure guidance for economic/funding aggregation from guidance on other regulatory reporting/enhanced monitoring including (but not limited to) sectoral limits and reporting, country limits and reporting
* A distinction between credit contagion, where Large Exposures monitoring/reporting is appropriate, and Liquidity contagion, which should not be treated under the Large Exposure reporting/monitoring, as it is already being appropriately managed through NSFR and LCR requirements (and regulatory reporting).

In our view the change in the ratio triggering Large Exposure reporting (from 2% of Own funds under CEBS and 5% of CT1 under BCBS to 2% of Eligible Capital under this CP) would lead to further unhelpful international divergence and result in an increase in operating costs and analyst resource consumption, which we deem to be material.

Whilst we are overall supportive of the principle of the CP, we consider that before it is finalised and implemented further consideration needs to be given to:

* Changing the trigger wording from “repayment difficulties”, which does not indicate the degree of severity required, to one that links it more explicitly to the risk of an event of default. The following definition is suggested, “material repayment difficulties, caused by direct economic and cash transmission links, that would make default highly probable”;
* Analyst judgment should be maintained when deciding on the need to aggregate regardless of level of ownership/economic/funding dependency;
* triggers listed under 23 a-j (section 6) should be **triggers for considering, not mandating,** aggregation:
* The nature of bankruptcy remote dedicated asset based SPVs (e.g. ship finance, Project finance, Aircraft leasing, Commodity Pre-export, CRE), either falling into the BCBS Specialised Lending category or demonstrating characteristics of true sale and purchase transactions. Such transactions should not automatically be subject to aggregation and we recommend that they are treated as standalone entities from Large exposures perspective, with aggregation on exception basis and based on analyst judgment;
* Treating conduits, warehousing SPVs and securitisation as stipulated in EU decision 1187/2014, with aggregation based on analyst judgment on both need to aggregate (for purposes of Large Exposure) and the actual level of aggregation (on basis of funding, income strip or other support guarantee). This would clearly reflect the “on risk” position and differentiate from the “externalised risk” position;
* Clarity on how settlement limits would be treated, including how to reflect them on a net (post collateral) basis which would assure the risk position is not overstated;
* Confirming that analysts would have the ability to apply their discretion on which entities (and to which level) are aggregated **across all types** of aggregation and not just for the Control grouping as per current CP wording.

We do not see a benefit in further amending the reporting trigger from 2% of Own funds (CEBS) to the proposed 2% of Eligible Capital. Furthermore we recommend that the trigger is aligned to the BCBS trigger of 5% of CET1 allowing similar treatment across key financial markets and achieving a competitive level playing field.

**Answers to Consultation Questions**

**Q1. Are you aware of any situations where the existence of a control relationship among clients does not lead to a “single risk”?**

There are numerous examples of entities where control relationship implied by share ownership may not translate into direct risk. These include Ringfenced Bank entities, dedicated securitisation conduits, SPVs used for Asset Backed Lending (e.g. Ship Finance, Aircraft Finance, Rolling Stock, etc), passive investment JVs, separate CRE investment SPVs, Commodity/Trade Finance dedicated flow bankruptcy remote structures, receivables warehousing SPVs, structured leasing SPVs in Aircraft/Ship/Rolling stock finance and structured finance vehicles (including Private Equity Investment Vehicles) and others.

**Q2. 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 need for exceptional disaggregation will always be present in relation to dedicated conduit/securitisation/asset backed lending and other bankruptcy remote/leasing structures. The impact of managing disaggregation by exception should not affect the costs further if the rules allowing exceptions and limitations to the treatment of conduits, BCBS Specialised Lending SPVs, structured leasing SPVs, JVs, etc are principles and analyst judgment based. Furthermore, we believe that to remove risk of overstatement and duplication analyst judgment should be:

* Applied across all three (Control, Economic, Funding) types of aggregation of connected entities and not just for Control aggregation a per current CP wording,
* Be allowed for disaggregation by product type.

**Q3. 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 Regulatin (EC) No 1606/2002 which should be clarified with respect to the large exposures regime.**

We do not see any need for further clarification from an accounting and accounting standard perspective. However, we recommend that EBA clearly allows for partial aggregation where the analyst deems it more appropriate.

**Q4. Are there any other indicators of control in the case of a similar relationship which are useful to add to this list of indicators?**

We do not recommend any additional triggers and recommend that aggregation is decided on principles based judgement by the analyst who will consider likelihood of direct economic/cash/risk transmission between entities as basis for aggregating. In this way the analyst can include all appropriate existing and/or future product types, structures and relationships between the different entities.

**Q5. What would be the cost of the assessment of the existence of control relationships in the case of subsidiaries exempt from accounting consolidation? Please provide an estimation of quantitative costs. In your experience how significant are these costs?**

Whilst in isolation the cost of assessing control relationships (including non-consolidated subsidiaries per individual client) should not be different from those that currently apply, the overall cost of assessment is expected to increase materially due to the overall approach, which includes:

* More entities being brought into the scope of assessment as the reporting trigger is reduced to 2% of Eligible capital vs. 2% of Own Funds under the CEBS current treatment and 5% under BCBS;
* The holistic assessment for each exposure which would under the proposal also include cost of additional Funding and Economic consolidation assessment, often including entities that are not clients (thus not obliged to provide data). This would in turn increase analyst time needed for the assessment (proportional to complexity of the entities). These costs would be material and numbered in weeks of analyst engagement for large complex clients (e.g. major manufacturers, energy or mining companies, transport companies, large funds and insurers, etc) that will have multiple touchpoints, sophisticated balance sheet and liquidity management and multiple supplier/investor/off-taker touch points;
* All of these would draw further on highly qualified analyst resource which is costly and scarce in the market.

For this reason we recommend that implementation takes a measured and phased approach allowing banks to gradually upscale teams allowing them sufficient time to optimise their processes.

**Q6. Is the guidance provided in Section 5 “Alternative approach for exposures to central governments” clear? If not please provide concrete suggestions.**

While the guidance is clear in the majority of cases, it does not appear to provide clear guidance on how to treat Public-Private-Investment contracts/concessions, which have both exposure to private sector contractors (e.g. performance bonds/undertakings, maintenance undertakings, etc) and public (for payments for delivery of service/infrastructure). We recommend that this is expanded on while highlighting the evident need that overall decision is based on analyst judgment, including level (and appropriateness) of full or partial aggregation.

**Q7. 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 clients? Please provide an estimation of any associated quantitative costs?**

We do not support the trigger being defined as “repayment difficulties”. This is too broadly drawn and may be interpreted to mean, (a) *any* delay in payments or (b) constraint to ongoing liquidity through higher usage of working capital financing caused by an issue with a supplier/off-taker/option or liquidity provider. The currently proposed approach disregards the reality that such events happen frequently in the normal course of business and are often mitigated by change in suppliers, counterparty, off-taker/sale on market, purchase of risk protection and/or change of financing provider, none of which are sufficiently severe as to trigger default. Maintaining the definition as proposed would thus disproportionally increase the scope of aggregation and analyst time used without a commensurate improvement in identifying true contagion risks. It is also very possible that it will be interpreted differently across the Union. Hence we recommend that trigger wording is changed to one that references the degree of ‘difficulty’ required by linking to the risk of an event of default. The following wording is suggested, “material repayment difficulties, caused by direct economic and cash transmission links, that would make default highly probable”.

**Q8. Are the situations describe in the list in Paragraph 23 as constituting economic dependency clear? If not, provide concrete suggestions. In particular, do you have any comments regarding the introduction of the threshold of “at least 50%” in points c), d), f) and g)?**

The introduction of a prescriptive 50% threshold unhelpful, if used as a prescriptive trigger for mandatory aggregation. Rather, we would consider it to be a positive addition if the 50% threshold, including all other triggers listed under 23 a-j, are presented as triggers for considering consolidation, with the decision to aggregate (or not as the case may be) remaining subject to analyst judgment.

We believe that the current proposal would greatly benefit if it were clear that the principle of aggregation to be followed in the event of the triggers listed in a) to k) is that *“direct cash/economic/risk transmission is likely between entities which would make default of the dependent party highly probable*”.

We also believe that further detail is needed to cover situations relating to:

* Infrastructure/Project financing;
* Trade Finance SPVs;
* Leasing;
* CRE Propco’s (individual asset holding SPVS) ;
* Conduits;
* An asset that may be 100% linked to a single supplier/off-taker, but where their failure would not lead to transmission of default across the group due to:
  + the nature of the asset and/or existence of a market for its expedient sale/conversion to cash, or,

* + inclusion of appropriate market norm clauses in legal arrangements, allowing to replace the off-taker/supplier in case of failure to meet obligations.

Paragraph 26 in section 3.2.3 of the background and rationale makes it clear that the guidance regarding common sources of funding remains the same as the original 2009 guidance. Some national supervisors have issued earlier more detailed guidance regarding the application of the 2009 guidance as it relates to SPVs that are connected to the firm itself. In order to avoid an expectation that national guidelines may require further review or revision we would welcome a confirmation in the final issued guidelines that none of the latest content further develops or alters the principles or detail espoused in 2009.

**Q9. 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**

Financial, ownership and especially economic relationships between entities are often bespoke, subject to specific contractual and/or regulatory arrangements and as such providing a prescriptive list of obligatory triggers (even more so if the list is expanded) could only lead to either lack (or overstatement) of aggregation. We recommend that an overarching change to the proposal is made with a clear principles based approach (see answer to Question 7 above) anchored by a list of examples and/or triggers that should launch consideration of aggregation (leaving the final decision on analyst judgment of the likelihood of default).

**Q10. 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.**

Guidance on Control grouping is clearer than others, although we again restate need for:

* More clarity on approach to bankruptcy remote (or shared ownership) vehicles
* Assuring that the level of aggregation (or decision not to), regardless of if it is on Ownership, Funding, Economic (or combination thereof) basis, remains on analyst judgment and is not prescriptive, instead a list of triggers for considering aggregation should be provided (leveraging on proposal from this draft guidance)
* Defining limitations/exclusions on bankruptcy remote SPVs/conduits/securitisations
* Amending the wording of trigger from “repayment difficulties” to one focused on materiality of risk of default – see response to Question 7 above

The background and rationale comments in section 3.2.5 recognise the inherent difficulties of exhaustively researching the economic connection between clients and, particularly, non-clients. The emphasis on taking reasonable steps to extract this information, where it is already known, is not however reflected in the guidelines in section 8 paras 33 to 38. For example

* Para 35 suggests “intensive” investigation should be “to the extent possible” which does not make clear that firms are likely to be limited in their information bases for different groups (and particularly non clients).
* Para 36 require the use of “all available” information, which can be read as meaning information that is available outside of the core credit process *must* be obtained without regard to cost or value, or potentially the robustness of the information.

There are significant concerns regarding the burden of collection which will fall upon customers who are likely to be the principal source of information, collecting them from their suppliers or offtakers (if and where possible). Firms will require quite granular information in order to be able to identify common sources of contagion in their datasets robustly. The transient nature of much of this information exacerbates this burden, and the cost of maintaining the data to a reliable standard. Furthermore, for commercial reasons, this information may not be obtainable as it is likely that customers’ off-taker or supplier may refuse to provide commercially sensitive inside information, as they are not a direct client of a firm and not legally/contractually obliged to), making the exercise fraught and potentially with limited/no benefit if interpreted as mandatory. It may also lead to unwillingness of firms’ direct customers to disclose further commercially sensitive information as the process becomes overly intrusive and exceeds contractual and legal obligations between customers and firms.

We recommend recognition of the difficulty of investigating and collecting non client information with it being amended so that the wording clearly **recommends** (rather than mandates) to include non-client information that is publicly available, or where that is not possible to what a firm can reasonably obtain directly from their customers or from the core credit process

Without such recognition the impact of this guidance is expected to bring a noticeable increase in costs which will be further exacerbated by reducing the increased due diligence threshold to 2% of Eligible capital rather than 2% of Own funds under current CEBS guidance or the 5% BCBS trigger. The divergence from BCBS trigger would also lead to different treatment between banks operating across different markets/having more than one regulator, increasing complexity and costs. As such we also strongly recommend that the new standards are aligned to the BCBS trigger ratio.

*For further information on this submission please contact Nemanja Eckert, Policy Director, BBA.*

1. https://www.eba.europa.eu/documents/10180/1531170/EBA-CP-2016-09+CP+on+Guidelines+on+Connected+Clients.pdf [↑](#footnote-ref-1)