German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on the EBA Consultation Paper on Guidelines on Connected Clients under Article 4 (1) (39) of Regulation (EU) No 575/2013

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The **German Banking Industry Committee (GBIC)** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the Savings Banks Finance Group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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I. General remarks

Instead of reviewing the guidelines at the present stage, enforce existing rules more strictly

In our view, the current rules on groups of connected clients adequately ensure that the concentration risk resulting from a close legal or economic connection between borrowers is captured and limited. We therefore do not believe that the review of the 2009 CEBS Guidelines initiated by the EBA is necessary at the present stage and are critical of the fact that this EBA review is not backed by any mandate in the CRD IV/CRR package. This applies particularly if the EBA's proposals were to result in stricter rules compared with current supervisory practice, as is happening through the tightening of the criteria for economic dependency and the new approach to the relation between control and economic dependency. This would, in our view, require an amendment of Article 4 (1) (39) of the CRR. Instead of proposing rules which would, de facto, be toughening current practices, European and national supervisors should devote more attention to uniform application of the existing rules based on the current understanding, i.e. the 2009 CEBS Guidelines.

Keep interplay with the current CRR review in sight

According to statements made by the EBA at the public hearing on 5 September 2016, its aims are finalising the guidelines in the first quarter of 2017 and putting these into force in the second or third quarter of 2017. With the ongoing revision of the European large exposures regime (CRR review, legislative proposal announced for the end of 2016) in mind, a review of the guidelines on connected clients does not make sense at the present time in our view. Due to the lack of clarity about the future framework for the European large exposures regime, the implications of the EBA's proposals – particularly the extent to which there is the threat of large exposure limits being exceeded and lending capacity being restricted – and thus the envisaged changes as a whole cannot be reliably assessed at the moment. The ongoing consultation process should therefore not lead directly to finalisation of the guidelines. Moreover, we do not believe there is any pressing need for regulatory action at present and would therefore suggest first awaiting the CRD IV/CRR review.

Ensure appropriate transitional periods in the final version of the guidelines

Irrespective of this, any final version of the guidelines should provide for long enough transitional periods before first-time application of the new rules. Institutions or the service providers they employ need enough time to prepare the required modifications of IT systems – at least 18 months from the date of publication of the final supervisory requirements. In addition, institutions will have to check all their loan exposures for conformity with the new rules and to widely adjust internal processes. For German banks, this means not only checking on correct formation of groups of connected clients but also paying attention to interaction with the grouping of borrowers for the national central credit register (Section 19 (2) 2 of the German Banking Act) and for the rules on loans to officers and related persons and on disclosure (Section 19 (3) of the German Banking Act, in conjunction with Sections 15 and 18 (1) of the German Banking Act). The final guidelines should be such that a routine review of existing loan exposures allows a check on conformity with the new rules and an examination of the impact on other areas of regulation.

Review the scope of the guidelines

As the EBA itself says, the concept of groups of connected clients within the meaning of Article 4 (1) (39) of the CRR applies not only in the large exposures regime. For consistency's sake, it would in principle be welcomed if the scope of the EBA guidelines were to be widened. Where regulation explicitly refers to groups of connected clients within the meaning of Article 4 (1) (39) of the CRR, the guidelines should be taken into account. Different guidance on how a given definition has to be applied in a specific regulatory context referring to that definition would seriously hinder its application in practice. With this in mind, we suggest reviewing the scope of the EBA Guidelines and thus of paragraphs 5 and 11 of the draft guidelines.

Economic dependency only in the case of sustained, existence-threatening repayment difficulties

Tying economic dependency to the existence of general financial difficulties irrespective of their duration and how serious their consequences are for the lending institution is something we reject as going too far (see also question 07). This is at odds with the purpose of Article 4 (1) (39) (b) of the CRR. Its purpose is grouping borrowers that constitute a single idiosyncratic risk which – were it to materialise – could pose a threat to an institution's continued operation as a going concern and is thus subject to a supervisory limit. This is only the case, however, if the failure of one client would very likely lead to substantial, sustained funding or repayment difficulties on the part of another client. The purpose of the provision therefore suggests an interpretation of the term '*repayment difficulties*' such that these should not only be temporary but instead substantial and existence-threatening. We therefore believe that, as rightly set out in the 2009 CEBS Guidelines, the criterion of '*substantial, existence-threatening repayment difficulties*' should be retained. Otherwise there is the threat of restricted lending capacities that could also adversely affect, in particular, the provision of funds to SMEs and would thus run counter to political efforts at European level.

An approach geared to the vague term '*financial difficulties*' would ultimately create new uncertainty when it comes to assessing the existence of a group of connected clients because there would then still be the question of how to understand such term and especially how serious the financial difficulties due to economic dependencies would have to be to lead to the assumption of a group of connected clients. Without any further clarification of the term, there is the – unintended – threat of inconsistent client grouping practice in Europe. Temporary financial difficulties, such as the involuntary granting of a supplier credit or difficulties resulting from the time needed to find a replacement for a customer that defaulted or the time to find a loan in order to pay claims as a guarantor, by no means justify formation of a group of connected clients based on economic dependency and thus treatment as a single borrower, since there is no sustained single risk. The risk of default for the institution resulting from such client relationships would be clearly overstated. As we understand it, the EBA also acknowledges this through what it says in paragraph 25 of *Background and rationale* subsection 3.2.3. May we additionally point out that in paragraph 19 of its large exposures framework the Basel Committee on Banking Supervision assumes that the crucial factor in formation of groups of connected clients is that two clients are so dependent on each other that if one of them fails the other will <u>very likely fail</u> as well.

Furthermore, in paragraph 27 of its large exposures framework the Basel Committee on Banking Supervision acknowledges that in cases of economic dependencies where a client is able to find alternative business partners or funding sources within an appropriate time period to overcome financial difficulties no combination of counterparties to form a group of connected clients would be necessary. Any gold plating at European level is unacceptable.

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General constitution of economic dependency based on hard thresholds is rejected

In our view, it always depends on an individual case whether there exists an economic dependency that constitutes a single risk. We believe that EBA shares this view taking into account paragraph 22. Therefore, hard thresholds can only be triggers for a comprehensive and profound analysis of economic dependencies and should not entail the obligatory formation of a group of connected clients. Thus, it should be further clarified that the criteria set out in paragraph 23 ***may*** constitute a single risk due to economic dependency (see proposal in answer to question 08 to amend the wording of paragraph 23 and question 09). This is important, because in the case of economic dependency analysis no rebuttal of single risk is possible, in contrast to the control concept.

Modify criteria for economic dependency through a common source of funding

We emphatically reject the proposed criteria for defining economic dependency through a common source of funding (paragraph 28 of the draft EBA Guidelines) (see also question 07). These would, in particular, have serious consequences for existing ABCP programmes. Sponsor banks would, for example, be forced to group the relevant purchasing companies or legally separated special-purpose vehicles into a group of connected clients. This is neither economically nor legally justified and would seriously restrict the financing of real-economy projects through this prudentially recognised product.

Set the same threshold for a thorough investigation of economic dependency as in the Basel Committee’s large exposures framework

The Basel Committee’s large exposures framework (paragraph 28) sets a threshold of 5% of eligible capital, defined as Tier 1, in relation to the aggregate exposure to a single borrower for a thorough investigation of economic dependency. Should the definition of eligible capital be aligned with the Basel Committee’s large exposures framework at European level, the relevant threshold should also be raised to 5% to prevent any gold plating at European level.

No interlinking of control and economic dependency

The proposed close relation between grouping based on control and grouping based on economic dependency is inappropriate in our view (see also question 10). Interconnectedness through control differs from interconnectedness through economic dependency. This is already acknowledged by the 2009 CEBS Guidelines (see paragraph 53). In the case of control, a contractual position/position under company law gives rise to a control relationship, so that shifts of assets by a controlling entity to the detriment of a lending institution’s recoverable assets are, for example, conceivable. This risk is to be cushioned through the formation of groups of connected clients. In contrast, economic dependency involves mainly risk-related interconnectedness resulting from bilateral business relationships and business orientation.

European legislators also clearly shared this view in both the CRR and earlier in the EU Banking Directive (Article 4 (45) of Directive 2006/48/EC) and made a point of separating these two grouping criteria. The phrase ‘*between whom there is no relationship of control*’ not only establishes, as we understand it, the precedence of control over economic dependency but also rules out any interlinking of the two criteria, as proposed by the EBA. Any general reframing of the relationship between control and economic dependency goes beyond the EBA’s mandate to ensure harmonised supervisory practice in Europe. In our view, such a basic policy decision would be up to EU legislators by amending Article 4 (1) (39) of the CRR accordingly.

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Likewise, the Basel Committee on Banking Supervision deliberately differentiates in its large exposures framework (paragraph 20) between the two criteria. It also dispenses with any provisions interlinking them. A requirement to interlink control and economic dependency in a group of connected clients may have far-reaching consequences that cannot be reliably assessed without examining all client relationships individually. Restrictions on lending would, however, be highly likely. The scale of these depends largely on further decisions at European level on implementation of the Basel Committee's large exposures framework, particularly whether the definition of '*eligible capital*' is tightened further and how far existing exemptions from the definition of "exposure" and from the application of the large exposure limit are dropped in future.

No excessive requirement to identify groups of connected clients

The information needed to correctly identify groups of connected clients is available in many cases. Yet there are often client relationships that are not based on 'classical' lending, but that are established through the purchase of a security issued by the client or recognised by way of a look-though, for example. In these cases, the required information would have to be obtained separately. This already imposes a considerable burden on institutions today. Any widening of this requirement to collect information would, in our view, be problematic and, given the experience made to date in identifying groups of connected clients, would also be unnecessary.

We have reservations particularly about the requirement following from the draft EBA Guidelines (paragraph 26, in conjunction with paragraph 36) to investigate the economic dependency of undertakings and persons that are not clients of the institution, and the associated requirement to obtain information about such dependency. In this context, and with example Mm1 in mind, it is not clear to institutions how far collection of information must go beyond their own clients to satisfy the requirements of Part B of the draft EBA Guidelines. In keeping with current practice in Germany, we believe that an investigation starting with the institution's clients and going as far as the next level is adequate. This practice is in line with the requirement in paragraph 59[1] of the 2009 CEBS guidelines and should be continued. Consequently, should the proposed interlinking of control and economic dependency be retained, the first sentence of paragraph 37 should be reworded as follows: '*[…] should collect information on all ~~entities~~ **clients of the institution** forming a chain of contagion*.'

In addition, the requirement in paragraph 34 of *Background and rationale* subsection 3.2.5 to collect and evaluate '*soft information*' that typically only exists at the level of individual loan officers and relationship managers, also for legal or natural persons connected to a client, is likely to lead to virtually impracticable data collection and collation. With regard to the requirement to obtain information, it should therefore be made clear that an investigation of economic dependency based on the institution's existing knowledge is generally sufficient[2] and that the phrase '*all available information*' in paragraph 36 of the draft EBA Guidelines should also be interpreted in this sense. We thus suggest that paragraph 26 of the draft EBA Guidelines be worded as follows: '*Institutions should form a group of connected clients where two or more of their clients **constitute a single risk because they** are economically dependent on an entity. **This shall also apply** even if this entity is not a client of the institution, **based on the present knowledge of the institution**. In such a case, the entity which is not a client of the institution does not need to be included in the group of connected clients.'* Furthermore, in line with paragraph 60 of the

[1] "*The institution, however, is not obliged to investigate whether the other entity, to which its client is interconnected, itself is part of other groups of connected clients, as long as the other entity is not a client of the institution*."

[2] cf. paragraph 38 of *Background and rationale* subsection 3.2.5: "*… to the knowledge of an institution*"….

2009 CEBS Guidelines and paragraph 38 of *Background and rationale* subsection 3.2.5, we believe the EBA Guidelines should stipulate that additional information necessary to assess interconnectedness should be gathered on a '**best effort**' **basis**.

II. Replies to the EBA's questions

Question 01: Are you aware of any situations where the existence of a control relationship among clients does not lead to a 'single risk'?

In the following, we present three particular individual situations. In these, it is unlikely that the controlled entity allows shifts of assets to its detriment that lead to the lending institution's recoverable assets being adversely affected. It is also unlikely that the controlled entity subordinates itself to an overriding group interest and is controlled by the controlling entity to such an extent that the failure of the group-wide business policy would create a single risk for the lending institution. The following examples are therefore situations where a control relationship exists but there is no threat of contagion (single risk).

Example 1: In the area of acquisition finance, a private equity firm, as a fund initiator and manager, usually controls a portfolio company. As a rule, private equity firms are licensed alternative investment fund managers according to the EU Alternative Investment Funds Directive, and their portfolio companies[3] qualify as alternative investment funds under this directive. In its role as general partner, a private equity firm exercises influence on the management of a portfolio company and makes investment decisions under the narrow investment mandate given to it by the investors (limited partners).
A private equity firm is not liable for its portfolio companies and the portfolio companies are not liable for each other. Shifts in assets between the portfolio companies are thus not allowed. Ultimately, while a legal control relationship exists between a private equity firm and the individual portfolio companies, there is no single risk that would justify full grouping.

Example 2: According to the Act governing the Deutsche Bundesbank, the Bundesbank's registered capital belongs to the Federal Republic of Germany. Because of this majority shareholding, a control relationship could be assumed. However, thanks to the Bundesbank's independent status established by law, no single risk exists. Generally speaking, we believe that, where a controlled entity is not bound by instructions as laid down by law or in its articles of association, no single risk exists. In such cases, it is unlikely that the existing formal control relationship based on agreements under company law can be used in practice to determine the strategy or the business, financial and earnings policy in the interests of the entity exercising control.

Example 3: Referring to IFRS 10, auditors call in many cases for the inclusion of SPVs in consolidated financial statements prepared in accordance with commercial law. Often it is sufficient that the group entity has sold the exposures to an SPV by way of a securitisation transaction, takes over servicing and holds a securitisation position as called for in Article 405 of the CRR (Retention interest of the issuer). Through inclusion of the SPV in the originator's consolidated financial statements, a case of control would

[3] Portfolio company means a company through which investments are made.

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have to be assumed and a group of connected clients comprising the SPV and the originator would have to be formed. No single risk exists, however. A very typical feature of many SPV types in practice is their bankruptcy-remote-style set-up. Such ring-fencing design typically results in most SPVs being economically independent from other parties' (such as the originator's) economic fate even if accounting rules require the relationship to be deemed a controlling one.

The wording of paragraph 12 of the draft EBA Guidelines should be amended in our view. The requisite degree of detail already follows from the requirement of third-party comprehensibility and is thus unnecessary. We suggest the following wording:
'Where institutions are able to demonstrate that no single risk exists despite the existence of a control relationship among clients, they should document the relevant circumstances which justify this case in a ~~**detailed and**~~ *comprehensible manner.'*

Question 02: 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 depends on the number of SPVs that are consolidateable under IFRS 10. Given the low threshold for '*contro*l' under IFRS 10 in particular (see question 01 above), the number of SPVs having to be regarded as a group of connected clients may, in individual scenarios, result in the relevant exposure to such a fictitious group becoming critical under large exposure thresholds and ultimately limits. It is therefore essential to be permitted to refute the notion of a 'single risk' if there is demonstrably no such connection.

See also our reply to question 04 regarding our understanding of the list of indicators and divergence between a majority of shares and a majority of voting rights.

Question 03: 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.

We welcome the clarification that the consolidated financial statements prepared in accordance with the provisions of EU law are to be taken as the main indicator of control within the meaning of Article 4 (1) (37), in conjunction with (39), of the CRR. At the same time, we take a critical view of the reference to IFRS 11 (Joint Arrangements). The term '*joint contro*l' does not constitute control within the meaning of Article 4 (1) (37) of the CRR and is therefore unsuitable as an indicator of control. Irrespective of this, joint control would not constitute a single risk either, as joint arrangements do not allow any joint shifts of assets ('stripping') to the detriment of the joint undertaking. We therefore request deletion of the reference to IFRS 11.

The same goes for the reference to IFRS 12. A shareholding in an unconsolidated, structured entity does not constitute control within the meaning of Article 4 (1) (37) of the CRR, nor does it constitute a single risk, as no shifts of assets ('stripping') to the detriment of the investor or the structured entity are possible. The formation of a group of connected clients would, moreover, not be practicable, as the exact counterparties covered by IFRS 12 are not named in the annual financial statements, nor do banking secrecy rules allow them to be named. We therefore request deletion of the reference to IFRS 12.

In addition, we suggest providing clarification by wording reference to the interaction between paragraphs 13 a) and b) and paragraph 13 c) of the draft EBA Guidelines as follows:
*'**In relation to clients to which points a) and b) of this paragraph do not apply** (e.g. natural persons, central governments, and clients which prepare consolidated financial statements in accordance with the accounting rules of a third country),…'.*

Question 04: 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 understand the indicators specified in paragraph 13 c) as a list of features that may indicate a control relationship; we do not believe that they should automatically do so. To make clear that each individual case must be viewed separately, we recommend wording paragraph 13 c), sentence 2 of the draft EBA Guidelines as follows:

*'When conducting this assessment, institutions should consider the following non-exhaustive list of indicators of control **and take into account the specific circumstances of each case**.'*

For example, a shareholding of more than 50% in another entity is specified as an indicator. Holding a majority of shares in itself only leads to control, however, if it is accompanied by a similar majority of voting rights or by other rights ensuring a dominant influence. Where, for instance, majorities in terms of shares and voting rights diverge, there is no control by a majority shareholder in our view. If the EBA understands the list of indicators differently, refuting a single risk would by no means be an exceptional case but the rule where majorities of shares and voting rights diverge. In Germany, this is the case for limited partnerships (*Kommanditgesellschaften*) with majority limited partners (*Mehrheitskommanditisten*) under standard articles of association. In this case, the limited partner, whose personal liability is limited to the amount of capital he has invested, holds the majority of the shares but merely has a right to information vis-à-vis the general partner (*Komplementär*).

We have reservations particularly about the '*blocking minority*' and '*management duties*' indicators mentioned under paragraph 13 c) iii, as well as the indicator listed under iv. Assessing a potential control relationship solely on the basis of such criteria is inappropriate in our view. Only if there are additional indicators can we imagine a control relationship being deemed to exist in such cases. As regards the individual indicators:

<u>Blocking minority (iii)</u>
Holding a blocking minority does not in principle constitute control. Under group law, the general consensus is that 'blocking' is not 'controlling'. Control is always understood in the sense of active participation, not blocking or preventing. A potential blocking minority does not constitute control for the purposes of IFRS 10 either. Control by using a blocking minority is only conceivable in very special situations, e.g. H-Bank can use a blocking minority in the case of Vermögensverwaltungs-GmbH and in this way exercise influence on BB-AG.

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Management duties (iii)
The performance of management duties in other entities can, in our view, only constitute a control relationship in special situations where there are additional indicators, e.g. in the private equity case outlined in the following. If the general partner, i.e. the fund initiator or an entity controlled by it, does not hold any shares or voting rights and could in fact be removed at any time, but makes all the key decisions and the investors – as is customary in such cases – do not want to control the company and also have no interest in removing the general partner, a case of control by the general partner can be deemed to exist. The situation is different with, for example, the general partner – replaceable at any time – of a US special-purpose entity in which only a few active investors have invested.

Right or ability to coordinate the management of an entity with that of other entities in pursuit of a common objective (iv)
We take it that this indicator is aimed at 'management on a unified basis'. Yet it remains unclear whether only 'vertical groups' (Article 22 (2) b) of Directive 2013/34/EU) or also 'horizontal groups' (Article 22 (7) b) of Directive 2013/34/EU) are meant. A 'vertical group' is deemed to exist if a controlling entity and one or more dependent entities are grouped together and managed on a unified basis by the controlling entity. In contrast, a 'horizontal group' is deemed to exist if legally independent entities are managed on a unified basis, without there being a dependency relationship between the entities. We should appreciate clarification to the effect that point iv only applies to 'vertical groups', as Article 4 (1) (37) of the CRR does not refer to Article 22 (7) b) of Directive 2013/34/EU. At the same time, it is difficult to check in practice whether natural persons hold multiple positions in management or other bodies in different undertakings. If point iv is meant to be addressed to 'vertical groups' as well as 'horizontal groups', we request clarification as to how groups of connected clients would have to be formed.
We also refer to question 08 and our comments on paragraph 23, point i.

Question 05: 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?

Question 06: Is the guidance provided in section 5. 'Alternative approach for exposures to central governments' clear? If not, please provide concrete suggestions.

We welcome the guidance on the so-called 'alternative approach'. The following cases could be additionally included: a central government has a 100% shareholding in both entities A and B. Entity A and entity B, in turn, each have 30% shareholdings in entities C and D, so that the central government exercises indirect control over entities C and D. How should groups of connected clients be formed if the alternative approach is applied? Proposal:

Group of connected clients 1: central government + entity A
Group of connected clients 2: central government + entity B
Group of connected clients 3: central government + entity C + entity D

Question 07: 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.

Tying the formation of a group of connected clients based on economic dependency to the fact that the failure of one client leads to financial difficulties for another client irrespective of their nature and how serious their consequences are goes too far, in our view, when it comes to capturing risk. As regards this point, which is highly important for the German Banking Industry Committee, we refer to our position as set out in the *General remarks* section on page 3.

Over and above this important point, we take a critical view of the requirements in paragraph 27 ff. on economic dependency through a main source of funding and thus emphatically reject these. More pronouncedly than the 2009 CEBS Guidelines, the EBA now implies that loans granted by the reporting institution itself can be regarded as such a common source of funding (see paragraph 28 of the draft EBA Guidelines). In this context, the EBA lists a number of indicative factors that may lead to the assumption of contagion or idiosyncratic risk (see paragraph 29 of the draft EBA Guidelines). In application of these factors, the EBA concludes in example E6 that an institution providing liquidity lines to several SPVs '*can constitute the source of risk (the underlying risk factor) as recognised in recital 54 of Regulation (EU) No. 575/2013'*. We believe that the approach taken in paragraphs 28 and 29 of the draft EBA Guidelines (and the conclusion drawn therefrom in the example) is not justified.

For one thing, liquidity risk resulting from securitisation programmes is, in our view, addressed here inappropriately in the large exposures regime, applying provisions of the 2009 CEBS Guidelines which were designed at the time to draw lessons from the sub-prime crisis. These provisions cannot automatically be applied to the situation today, however. Adoption of these provisions would, in particular, fail to take into account that through changes to capital requirements for securitisations and the introduction of a short-term liquidity coverage ratio (LCR) rules addressing the undesirable developments in the subprime crisis have been issued in the meantime. We share the EBA's view that the liquidity lines to A, B and C in example E6 could be drawn on simultaneously because the event triggering such drawing (general market disruption) is ultimately identical or at least similar. However, we believe this is exclusively a liquidity management issue and should therefore also be treated as such.

For another thing, the interpretation of example E6 ignores the fact that credit risk resulting from securitisation transactions is captured very effectively via the look-through rules (EU Regulation 1187/2014). Under the look-though approach, the underlying assets are taken into account, whereas in example E6 there is a look back at the liquidity provider. The provisions of the EU Regulation also set a materiality threshold of 0.25% of eligible capital. Any aggregation of SPV exposures at the level of an artificially formed group of connected clients would undermine application of the materiality threshold.

Besides these fundamental concerns, the following points are, in our view, further arguments against application of paragraphs 28 and 29 in their present form:

First, sectoral concentration risk falls outside the scope of the large exposures regime (see *Background and Rationale* section, paragraph 7 on page 7). Therefore, it is undeniable that the fact that several clients tap the same banking or capital market segment (e.g. for commercial paper in general or ABCP in

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particular) for funding purposes does not constitute a dependency which may justify treatment as a 'single risk' within the meaning of Article 4 (1) (39) (b) of the CRR. Unfortunately, however, the EBA's proposal does not shed any further light on the crucial distinction between a funding source that constitutes a 'market' and, therefore, a sectoral concentration risk (outside the scope of the large exposures regime) and a funding source that constitutes an economic dependency within the meaning of Article 4 (1) (39) (b) of the CRR.

<u>Second</u>, the large exposures regime aims to prevent situations in which '*excessive concentration of exposures to a client or a group of connected clients may result in an inacceptable risk of loss'* (see recital 53 of the CRR). Based on that legislative intent, we believe that the fact that loans to different customers are granted by a single institution is, at least from the perspective of such institution, an intrinsic fact that should not, per se, constitute a relevant economic dependency between those clients and a risk of excessive concentration for that institution. In this context, we believe that recital 54 of the CRR is misconstrued. If the EBA's reading of recital 54 and Article 4 (1) (39) (b) of the CRR were correct, it would lead to circular reasoning, as then, logically, any and all exposures to separate clients of an institution must be seen as interconnected, which, in turn, would render the entire concept of the large exposures regime nonsensical and useless. In our view, this should not be the result of its application. Accordingly, we believe that an institution must instead look at extrinsic facts or circumstances (in terms of funding sources e.g. lending by other entities or the absence thereof) that may or may not connect clients into a single economic risk unit.
From the perspective of the sponsor bank, it is the funding via the ABCP market that matters. The funding via ABCP is, however, an extrinsic risk factor that is, at the same time, a sectoral concentration risk that cannot by itself constitute an economic dependency within the meaning of Article 4 (1) (39) (b) of the CRR. From the perspective of a third institution investing in any commercial paper issued by A, B and/or C and relying on the sponsor support (rather than the quality of the underlying assets acquired by the SPV), the facility of the sponsor bank may matter and the analysis may therefore be different: the investor institution may come to the conclusion to treat all SPVs as a group of connected clients because of the common liquidity support by the sponsor bank.

<u>Third</u>, the situations (or factors) listed in paragraph 29 of the draft EBA Guidelines (which were taken largely from the 2009 CEBS Guidelines) are not selective and hence not suitable for providing a meaningful differentiation of sectoral concentration risk and for appropriately assessing '*contagion or idiosyncratic risk*'. They seem to be arbitrarily designed to capture certain ABCP or SIV structures which ran into trouble during the financial crisis, but they are extremely broad and ambiguous and therefore go too far:

- Why should the '*use of the same investment advisor'* by itself lead to contagion risk? Would that factor then capture all SPV, fund and trust structures advised and managed by the same investment management company?
- What does '*use of similar structures'* mean? What does '*similar*' mean? Similar to what? What is the connecting element here?
- Why should the '*use of similar underlying assets'* by itself lead to contagion risk, and has this fact anything to do with a common source of funding?

In addition, the draft EBA Guidelines omit to clarify that these criteria are only given as examples. If these criteria are to be applied literally (and mechanically), we are afraid that institutions would be

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required to connect and group totally unrelated and segregated SPV and fund structures into one economic risk, which evidently makes no sense. Hence, we believe that the use of ambiguous and non-selective factors will not provide any further clarity and certainty but in fact have the exact opposite effect.

<u>Fourth</u>, as stated above, the large exposures regime aims to avoid the accumulation of losses due to concentrations (see recital 53 of the CRR). The sectoral dependence of SPVs A, B and C on refinancing (i) via the ABCP market and/or (ii) credit facilities provided by the bank has no effect on the risk of loss from the perspective of the bank providing the credit facilities. Whether the ABCP market is functional or not does not increase the risk of loss if a credit facility is drawn on. While it increases the probability of a utilisation of the credit facility, it has no effect on the probability of repayment of the credit facility. Liquidity aspects are, however already covered to the greatest extent possible in the LCR provisions for securitisation liquidity facilities. Sectoral dependence on ABCP capability is not therefore relevant, as it has no impact on the risk of loss.

<u>Fifth</u>, we understand that, contrary to all general principles, example E6 constitutes a group of connected clients through common funding via the bank itself. However, the SPV does not face any danger, as the refinancing provided by the sponsor bank is entirely at matching maturities. Even if a sponsor bank were to drop out, no risk of loss arises from this scenario, as the SPV would cease to purchase new assets and would repay outstanding drawings out of the proceeds. The worst-case scenario would be the wind-down, but not the insolvency or exposure to loss, of a SPV. Unlike an operating company which depends on unterminated credit lines to continue its business, a SPV requires these only to do new business, as all existing business is fully refinanced at matching maturities. On this basis, especially example E6 cannot constitute a single risk as, regardless of any potential refinancing by a third bank (which would also be possible), the insolvency of the bank would not endanger repayment of any drawings.

<u>Overall</u>, we believe that such an approach may lead to unwarranted (and probably unintended) consequences: first, taken literally, the proposal would lead in general to any SPVs as clients (especially in securitisation or specialised lending structures sponsored by an institution) now becoming a group of connected clients despite the fact that the relevant risks may be appropriately segregated (legally and economically) and hence in fact no excessive single concentration risk exists. We believe that such regulation or any application thereof by a competent authority conflicts with the principle of proportionality which the provisions of the CCR aim to preserve (recital 46 of the CRR).

What is more, although the European ABCP market and the related structures have changed dramatically over the last few years since their lapse during the 2007 financial crisis, the EBA's proposal would, in particular, capture still existing ABCP programmes in Europe which are now trying to comply to the fullest possible extent with the new regulatory framework applicable to securitisations in Europe and are being used almost exclusively to finance the acquisition of real economy assets. The crucial element combining all such programmes is the fact that the investors in the ABCP basically rely on just one bank as sponsor to provide the full liquidity and credit support (instead of several liquidity banks, so-called 'fully supported ABCP conduits'), which is, per se, a result of the application of the self-retention requirements (Article 405 (1), sub-paragraph 2, sentence 2) and related own funds and liquidity requirements in the CRR. Furthermore, the full liquidity support by the sponsor is the crucial requirement for ABCP to qualify as STS under the upcoming EU securitisation regulation. We believe that the large exposures regime (as now proposed and interpreted by the EBA) is not appropriately harmonised with the self-retention, own funds and liquidity requirements contained in the CRR and is hence inconsistent with these requirements.

Finally, the treatment proposed by the EBA may significantly limit the ability of European sponsor banks to promote financing of the real economy above their individual large exposure limit without justification. Promoting financing of the real economy in Europe, particularly through high-quality securitisation (including ABCP) is inconsistent with the aim of other EU bodies (the Commission, Council and European Parliament). We therefore believe that this specific guideline does not serve its own purpose and also contradicts other legislative initiatives (like the CMU).

We therefore suggest deleting paragraphs 28 and 29 of the draft EBA Guidelines in their entirety and including instead selective criteria for assessing '*economic dependency through a main source of funding'* (following up the criteria contained in paragraph 45 of the 2009 CEBS Guidelines): dependency is deemed to exist when (i) there is just one single source of funding (entity) which (ii) must be replaced but is not replaceable within an adequate timeframe and (iii) the respective clients are not able to overcome their dependence on such source even by taking on practical inconvenience or higher costs. In this respect, we suggest also clarifying that, from the perspective of a reporting institution, only the dependency on external funding sources (as an extrinsic factor) should be taken into consideration and assessed.

Notwithstanding the preceding, by way of clarification, at least the reference in paragraph 26 of *Background and rationale* subsection 3.2.3 to the fact that '*a common source of funding due solely to geographical location does not, in itself, lead to a requirement to connect clients'* should be incorporated into the Guidelines themselves.

Question 08: Are the situations described 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)?

In our view, the criteria set out in paragraph 23 can, at best, only serve as indicators of a grouping of clients based on economic dependency. It thus needs to be examined on a case-by-case basis whether the formation of a group of connected clients is appropriate and a single risk exists. This examination can ultimately also mean that a single risk is not assumed to exist for an institution and there is no requirement to form a group of connected clients. We therefore suggest – in line with paragraph 22 – amending paragraph 23 of the draft EBA Guidelines as follows:

*'Institutions should ~~deem~~ **consider**, in particular, the following situations **that may** ~~as~~ constitut**e**~~ing~~ a **single risk based on** economic dependency:'*

In addition, we are strongly opposed to EBA's idea, set out in the explanatory box accompanying question 08, to potentially group mutually independent clients whose exposures are guaranteed by the same guarantor. The risk of the guarantor encountering financial difficulties would only occur if several or in fact all guaranteed debtors were to default simultaneously. This contagion risk is, however, extremely low because of the debtors' independence; grouping the independent clients would significantly overstate the risk for the lending institution.

We agree in principle with paragraph 23, point b) of the draft EBA Guidelines. Where, however, liability is accompanied by a majority of shares or voting rights or where several persons are liable for an undertaking and each of these persons can conclude material, binding contracts for the undertaking with third parties, we would assume that this is primarily a case of control. Moreover, the situation referred to in paragraph 23, point b) of the draft EBA Guidelines is already covered, in our view, by the phrase '*or is liable by other means*' in paragraph 23, point a).

Looking at paragraph 23, point c) of the draft EBA Guidelines, we would request additional clarification that no dependency on a tenant exists where a replacement can be found in the marketplace, i.e. the property is available for third-party use. Replaceability is expressly mentioned in regard to a single client (paragraph 23, point d)) of the draft EBA Guidelines) and to a small joint group of clients (paragraph 23, point h)) of the draft EBA Guidelines). This naturally goes for a tenant as well, though express reference to this effect is missing.

The requirement in paragraph 23, point e) of the draft EBA Guidelines should also be amended to include the requirement that no alternative source of income is available at short notice either. We suggest the following wording:

*'When the expected source of repayment for each loan granted by the institution to two or more clients is the same and neither client has another source of income from which the loan may be fully repaid **and is not able to substitute the current source of income easily.**"*

We also request further details of which cases are to be covered by paragraph 23, point g) of the draft EBA Guidelines.

We fail to understand the provision on 'horizontal groups' in paragraph 23, point i) of the draft EBA Guidelines. A 'horizontal group' exists where several mutually independent undertakings are managed on a unified basis. If personnel links alone were to really constitute economic dependency, Article 22 (7) b) of Directive 2013/34/EU would not have left it to Member States to decide whether to require undertakings to prepare consolidated financial statements. We therefore request deletion of the wording in question, particularly also in the light of what the EBA might have in mind regarding the indicator of control under paragraph 13 c) iv) of the draft guidelines (see our remarks on paragraph 13 c) iv) in our reply to Question 04).

Question 09: 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, as not all conceivable cases can be captured and economic dependency always depends on the specific circumstances of each case. However, the principle leading to identification of a single risk based on economic dependency is clear. We therefore agree with paragraph 22 in section 6 of the draft EBA Guidelines where it says that, when assessing the existence of a group of connected clients based on economic dependency, the specific circumstances of each case should always be taken into account. In keeping with this principle, it should be made clear in paragraph 23 of the draft EBA Guidelines that the situations listed therein **may** constitute a single risk based on economic dependency (see our remarks on paragraph 23 in our reply to Question 08).

The indication of thresholds is therefore basically to be welcomed in our view, as this would make the formation of groups of connected clients based on economic dependency easier in banking practice and would eliminate uncertainty. However, such thresholds should be designed as supervisory benchmarks, i.e. they should have indicative character, so that upward and downward deviations are possible in justified individual cases.

In addition, paragraph 26 of the draft EBA Guidelines should be reworded and, in line with the situation outlined in example E2, added to in such a way that an entity that is not a client of the lending institution does not have to be included in a group of connected clients needed to be formed between two or more clients of the institution (see our proposal for the wording of paragraph 23 in the *General remarks* section – *No excessive requirement to identify groups of connected clients*. Like in paragraph 26, clarification should then also be incorporated into section 4: *Group of connected clients based on control* to the effect that only those entities that receive loans from the institution have to be included in a group of connected clients.

As concerns the assessment of economic dependencies between shadow banking entities, we understood the EBA in the public hearing as follows: the wording in paragraph 24 of the draft EBA Guidelines reading '*Institutions should give due consideration to the fact that relationships between entities falling under the definition of shadow banking entity will most likely not consist of equity ties but rather of a different type of relationship, i.e. situations of de facto control or identifiable by contractual obligations, implicit support, or potential reputational risk (such as sponsorship or even branding)*' is not intended to mean, with respect to shadow banking entities, that implicit support or joint branding may lead to the formation of a group of connected clients. We are strongly opposed to any requirement to form a group of connected clients that is not consistent with this understanding. May we refer in this context to the Basel Committee on Banking Supervision's still-to-be-completed work on step-in risk and the German Banking Industry Committee's comments on the consultative document on '*Identification and measurement of step-in risk*' (BCBS 349) (Enclosure). We therefore agree that the indicators listed in paragraph 23 of the draft EBA Guidelines also apply to shadow banking entities within the meaning of the EBA Guidelines EBA/GL/2015/20. At the same time, we see no need to incorporate this explicitly into the guidelines on groups of connected clients. For this reason, we request deletion of paragraph 24.

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.

Interconnectedness through control differs fundamentally from interconnectedness through economic dependency. Any obligation to link these may lead to far-reaching requirements for the formation of groups of connected clients. We are opposed to such an approach, as this would go beyond the requirements set in Article 4 (1) (39) b) of the CRR. The extent to which this would lead to restricted lending is something that cannot be reliably assessed at the moment. This depends to a large extent on further decisions at European level on implementation of the Basel Committee's large exposures framework, particularly whether the definition of 'eligible capital' is tightened further and how far existing exemptions from the definition of "exposure" and from the application of the large exposure limit are dropped in future (for further details, see also section 1: *General remarks*).

If the EBA maintains its proposal on the relation between interconnectedness through control and through economic dependency, it should also be made clear how the two criteria – control and economic dependency – are to be separated and applied if both occur in parallel but in different directions. The following example serves to illustrate this:
A holding company has a 100% shareholding in a subsidiary and the holding company is at the same time economically dependent on the subsidiary. The subsidiary, in turn, triggers a further economic dependency on a third party (legally independent entity). Which entity should be placed at the top of the group of connected clients? The subsidiary (which triggers the economic dependency) or the parent undertaking (as the controlling entity)?

In addition, the example of upstream contagion should be numbered C/E 4 and not C/E 2. May we also point out that in both the example of downstream contagion and the example of upstream contagion the arrow between A2 and B1 should point in the opposite direction; in both cases, B1 is dependent on A2.

As examples promote an understanding of the guidelines and their application in practice, the examples already included in the *Background and rationale* section, expanded to include further cases, should be moved to the final guidelines in the narrow sense (i.e. to the *Draft Guidelines* section) if the EBA decides to stick to its idea to interlink the criteria of control and economic dependency. Experience shows that only this part is translated into the official EU languages.