Association for Financial Markets in Europe

Consultation response

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

26 June 2017

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Banking Authority's (EBA's) consultation on the scope of the draft Guidelines on Connected Clients under Article 4 (1) (39) of Regulation (EU) No 575/2013. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We have included our response to the questions raised in the consultation below. However, please note that the EBA consulted on Guidelines on Connected Clients in July 2016[1] to which AFME responded and highlighted a number of issues. As those guidelines are yet to be finalised, this response is based on the assumption that those issues persist and we ask that you read our response to the original consultation (see Appendix) in conjunction with this response.

Question 1 – Do you agree with this approach? Please explain how the application of the draft guidelines with the amended scope would possibly affect current practices

As a general principle and in line with the CRR article 4(1)(39), we appreciate the EBA's effort to harmonize and simplify, however it is important to recognise that the Large Exposures (LE) framework and capital framework have different objectives and the definition of the principles followed for recognising exposures in each is, and should be, different.

The LE framework aims to control potential single points of failure caused by acute idiosyncratic risk concentrations. It takes a conservative view of how exposure may aggregate to identify the groupings of concern, with, for example, exposure being counted multiple times against different obligor groups to produce a worst case view.

The pillar one capital framework aims to present a view of risks based on likely economic performance across a portfolio, leaving issues of concentration to be considered under pillar 2. From a normative viewpoint, the Pillar 1 capital framework is built in a more granular manner in order to better take into account specific features relevant to each exposure class, while the LE framework is a key supervisory backstop dealing with single-name concentration risk.

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

In each framework, it is important to have the right tool for the right job and this means that having different views of how to group entities in each framework should not be viewed as problematic. For this reason, we disagree with the alignment, and in particular the extension of definition to encompass groupings for reasons of economic dependence.

The LE framework includes a materiality threshold for intensive investigation of potential economic connections. We noted in our response to the original consultation that the 2% of eligible capital threshold for intensive investigation of potential economic connections remains inconsistent with the 5% of Tier 1 capital threshold recommended by Basel and should be reconsidered as part of these revisions. Additionally, it should be noted that the materiality threshold becomes undermined with an extension of the scope of application, as identifying economic dependencies would require a bottom up approach to be implemented effectively to inform the exposure measure and associated risk weights accurately.

Economic dependence as a basis of assessing connections creates a number of unintended consequences if extended to Pillar 1 and Pillar 2 requirements:

- Volatility, arising from the constantly changing perimeter as dependencies change.
- Variability, as banks exercise their judgements and reach different conclusions, thereby resulting in different exposures, even where the direct exposure may be the same. Additionally, the difference in exposure measures between those banks using external ratings, versus those using internal ratings will vary significantly as external ratings agencies do not consider connected clients in the same way. As such, there will be increased variability in RWAs, reducing comparability across banks
- RWA growth, as economic dependence will result in retail exposures being inflated by non-retail exposures and in certain cases, these exposures will be moved outside the retail classification and attract a 100% risk weighting. SME exposures will be inflated and in some cases these exposures will no longer be eligible for the SME supporting factor. Credit concentration risk will increase as entities are captured multiple times across different groups of connected clients, double counting a risk which is already a part of the risk based capital framework.

These issues may be exacerbated by the proposed change in requirement to form a group of connected clients when failure of a client would lead to ‘repayment difficulties’ from the 2009 CEBS Guideline expectation of ‘substantial, existence-threatening repayment difficulties’. As noted in response to the original consultation, it would be helpful to provide a more precise definition of ‘repayment difficulties’ and to closely link its definition to the event of default to avoid the unintended consequences; we believe this should mean repayment difficulties where the default of the counterparty is highly probable.

It should be noted that the operational burden of investigating dependencies in the retail and SME populations and the capital impact of these proposed changes is likely to disproportionately affect smaller institutions i.e. banks with a smaller capital base. The increased retail exposure arising from aggregation with connected clients would likely be insignificant with those with a large capital base, but more meaningful for smaller institutions, who would be required to intensively investigate these exposures where a 2% of capital base threshold and the size criteria for retail and SME treatments overlap. Firms with larger capital bases are unlikely to be required to investigate exposures that come near these retail and SME definitions. Members are concerned that this unfairly penalises smaller firms.

As noted in the previous consultation response, in the process of identifying economic dependencies and as recognised in the Guidelines, it will rarely be possible to implement automated procedures. The process for identifying connected clients is operationally complex, in particular where connections are vis-à-vis parties that are not an institution's clients (indirect counterparties). In addition to the practical difficulties in identifying such dependencies, this will have material cost implications for institutions and we ask that the requirement to identify economic dependencies not be extended to beyond an institution's client base. The cost implication is amplified in relation to investigating potential economic dependencies of entities / parties that are not part of an institution's existing client base as attaining the information will be more difficult and the costs associated with building IT systems and storage capacity for this information will be significant.

There will also be implications for the customer relationship as well as the capital implications noted above. In particular, additional information, potentially client confidential information, would need to be retrieved directly from the clients in order to assess the existence of an economic link in the new definition. As such, clients will need to accept that they are considered part of an economic group when their overall risk profile is being assessed, despite them having no control over parts of that economic group. Smaller customers of smaller firms will face increased costs of borrowing and other services as firms seek recompense for the higher capital requirement that results.

For both larger and smaller firms, it is unclear whether the materiality threshold is expected to operate at both solo and consolidated levels for the purposes of the Consultation. If it applies at both, all firms will be faced with a burden of having different capital calculations, or indeed asset class assignments, for the same obligor at each level. It would be incoherent to have different views of the capital requirement reported for the same economic risk within the same organisation. It will also lead to differences in pillar 3 reporting which may confuse users of these statements.

Finally, regulatory reporting will overstate the risks being run by banks as risks to the same client are captured in multiple groups.

Retail exposure class

Question 2: Please explain how the application of the draft guidelines on connected clients would possibly change current practices regarding the categorisation of retail exposures?

A widespread application to retail exposures is difficult and in our assessment, there are significant barriers to allow effective implementation. The issues are both legal, operational and systems related.

There is a lack of available data. For large corporates, there is publicly available information about control relationships and, perhaps an ongoing relationship banking model to exploit in seeking further information. This is not the case for retail clients as there is no publicly available management information and the banking model is more likely to be transactional or product led rather than relationship based. It is very likely that firms will be forced to assume broad connection relationships without the benefit of intensive investigation. Furthermore, this issue is exacerbated when considering natural persons where the cost-benefit of collecting such information would not be justified. Exposures of natural persons would unlikely exceed the threshold for intensive investigation, and creating systems to track connections would be near impossible and unaffordable in most cases. We do not believe, for instance, that a natural person should be grouped with his / her employer due to economic dependency. Whilst we do not believe this to be the intention of the Guidelines, the expectations should be made clear. In particular, we recommend that natural persons are exempt from the requirement to make an economic interdependence assessment under Article 123. We believe the proposals as currently drafted are not in line with the CRR as introducing the assessment would make it difficult to argue that the exposure is meeting Article 123(b).

The proposals would create a disconnect between requirements and how banks manage their retail exposures. Retail exposures are typically managed on a portfolio level in each entity, not individually. Retail decisions are generally based on scorecards and automated credit decision systems and focus is on speed of processing. This is very different approach from credit assessment for large corporates where there are multiple points of client contact and discussions. Additionally, there is minimal client contact (for performing loans) after the retail loan / facility is granted. (For example, reviews are not conducted for instalment loans. For facilities, e.g. credit cards, where reviews are required, automated credit decision systems are used.). These issues are compounded with the large numbers of client in retail. As such, aggregation of all the required retail information in all the subsidiaries will be practically unfeasible.

In certain jurisdictions there are legal restrictions in obtaining data due to client data protection issues. In some instances, there may be difficulties in sharing information within the same jurisdiction; there may be walls (information barriers) between departments to protect confidentiality of client information (e.g. private banking wall) within an institution that would prevent the economic dependency test from being performed. Information sharing can be even more complex between jurisdictions e.g. obtaining client sensitive data from the US and the cost implication and investigatory burden for those with operations in many jurisdictions would be significant, even more so than the already disproportionate costs that would arise from implementing these standards in a single jurisdiction, requiring significant systems investment.

As such, it should be clear that any extension of scope of application of the LE framework would be on a reasonable efforts basis. Banks should not be made accountable for information that is not available, or not made available by its customers or counterparts. Additionally, connections, particularly arising from economic dependencies, are likely to change frequently and a bank can only reasonably be expected to update this information when going through its regular review cycle or information is brought to its attention that a dependency has changed.

Besides the operational issues, we believe it is inappropriate to mix retail exposures with non-retail exposures. A number of retail connected client groups will be overinflated with larger corporate exposures and exceed the €1million threshold. This will mean that retail clients will attract a 100% risk weight, as opposed to the 75% risk weight for retail clients which recognises the diversification effect of these exposures on a portfolio level, thus disincentivising such diversification and potentially resulting in a "RWA growth" effect.

It should be noted that the preferential capital weighting given to retail customers recognises the benefits of diversification across a wide pool. Such customers default for a very wide range of reasons and there is no evidence to suggest that connected obligor contamination is predominant among them. By seeking to emphasise this particular mode of failure in pillar 1 capital ignores the fact that, most of the time, customers fail for other reasons unconnected to any dependency – such as changes in debt affordability caused by illness, divorce or unemployment (where the employer remains a going concern). There is no evidence that the risks of the population, when viewed holistically, are in any way significantly underpinned by unidentified dependencies that warrant the effort of identification and differentiated reporting that would be required.

Finally, it should be recognised that removing the designation of an exposure as retail will alter its asset class assignment, potentially leading to exposures being reported in different ways in different periods based on changes in materiality threshold for economic dependency investigation or changes in views of the degree of an obligor's dependency. It is undesirable to have asset class assignments driven by matters of opinion or judgement rather than objective obligor characteristics.

Rating systems

Question 3: Do you agree with the EBA's assessment that there would be no impact of applying the draft guidelines on connected clients to development and application of the rating systems (Article 172(1)(d) of the CRR)?

We welcome the EBA's opinion that there will be no direct impact of the application of the draft guidelines on the rating systems, as Article 172(1)(d) of the CRR clearly requires that a separate rating shall be provided to each separate legal entity and that institutions shall have appropriate policies regarding the treatment of groups of connected clients.

It is our view that any change in methodology or expectation that would require ratings to be performed on the basis of groups of connected clients, would give rise to significant complications should the grouping be required to accommodate economic dependence:

The inclusion of economic dependencies would lead to a double counting of entities across multiple aggregation groups. Different institutions will make different judgements in respect of economic dependencies and this will result in increased variability in ratings, which is counter to Basel and EU's objectives of reducing variability in credit risk weights. Additionally, this would create a greater disparity between those using external ratings (that do not consider economic dependencies in the same manner) and internal ratings, again exacerbating variability in credit risk weights. The frequency of changes in economic dependencies would also add significant volatility into capital requirements. Rating entities repeatedly across multiple aggregation groups, as a result of an entity being considered in the overall credit assessment for each group of connected counterparties in which it sits, will also likely to lead to RWA growth.

Additionally, in the event of any revised expectations, we would also like to re-iterate the concern raised in our initial consultation response in respect of the extension of the potential "single risk" perimeter moving from the "substantial, existence threatening repayment difficulties" concept adopted by the currently in place 2009 CEBS Guidelines to the simple "repayment difficulties" perspective proposed by the new EBA Guidelines. In addition to the points noted in our initial response, we would like to highlight the implications on modelling. The counterparty rating assessment would be extended to a larger number of entities included in the group perimeter due to an economic connection, therefore impacting the appropriateness of the rating on a single obligor and consequentially the applicable pricing and the relative capital absorption. The link between default event and information on economic links will likely weaken given the extension of the rating assignment perimeter, embedding the group link function to a broad range of obligors. In this regard, CRR Article 174(a) states that "the model shall have good predictive power and capital requirements shall not be distorted as a result of its use. […]".

This change in fundamental obligor/obligor group identification will clearly at worst require models to be rebuilt, or at best recalibrated. For example, some firms may have chosen to reflect the existence of idiosyncratic economic dependencies in different ways in the design of their models. If such dependencies are forced instead to be reflected in the obligor grouping itself, such models will have to be formally redeveloped. The redevelopment costs and reapproval overhead are likely to be profound.

Moreover, although Paragraph 61[2] of the EBA GL on Definition of Default states that default is identified at an individual obligor basis, due to the enlargement of the concept of economic link to

[2]*Where such criteria have not been specified for a non-standard situation, in the case of default of an obligor that is part of a group of connected clients, institutions should assess the potential unlikeliness to pay of all other entities within this group on a case-by-case basis*".
https://www.eba.europa.eu/documents/10180/1597103/Final+Report+on+Guidelines+on+default+definition+%28EBA-GL-2016-07%29.pdf/004d3356-a9dc-49d1-aab1-3591f4d42cbb

the pure “repayment difficulty”, the economic groups perimeter is expected to comprise more counterparties and as such in case of default of one member the need for assessing the potential unlikeliness to pay (UTP) classification might be potentially extended to a much broader perimeter of companies with a twofold implication:

- the enlargement of the perimeter to be assessed and hence the additional workload might jeopardize the accuracy of the default/non-default classification given the bank’s limited capacity;
- as a consequence of a potential negative impact on modelling side (as already explained), the link between default event and information on economic link might be diluted.

SME supporting factor

Question 4: Please explain how the application of the draft guidelines on connected clients would possibly change current practices regarding the use of the SME supporting factor?

Similar to the issues raised for retail exposures, there will be increased volatility and variability in capital requirements and there are legal, operational and systems limitations to implementing the guidelines in relation to SME exposures:

- Volatility and variability arise from the constant changes in group perimeters as dependence changes.
- Legal challenges, such as client confidentiality limiting the distribution of relevant data, make it difficult to perform the economic dependence test.
- Operational and systems limitations arise from the difficulties in implementing automated procedures, with the process for identifying economic dependencies (including indirect dependencies) being operationally complex.

These issues, as noted, arise primarily due to the need to capture connections arising from economic dependence.

In relation to the SME supporting factor, it is likely that the application of the draft guidelines, particularly economic dependence, will enlarge some group of connected clients, adding additional counterparts and related exposures. That will result in a higher number of groups exceeding the threshold of €1.5 million of exposure and in their exclusion from the application of SME supporting factor. As the industry has been advocating that the €1.5 m threshold was excessively low to make the SME SF effective, we cannot but express our disagreement towards this proposal which would further restrict the scope of application of this capital discount. Moreover, this provision would also weaken to a certain extent the effectiveness of some current EU regulatory developments. Being aware of the need to boost the use of the instrument, the EU Commission has recently proposed to revise the CRR to extend the application of a SME SF (albeit higher) to the portion of the exposure exceeding €1.5 m. The EBA proposal seems instead to move in the opposite direction, relatively reducing the applicability of the SME SF. As a consequence, RWA are hence expected to unduly grow and capital relief to reduce.

The SME supporting factor was first introduced in the context of credit tightening after the financial crisis to provide an adequate flow of credit to SMEs. Inflating the exposures of SMEs will remove this support and much needed credit line.

Moreover with reference to the SMEs, it is worth mentioning that assuming the application of economic dependence per the draft guidelines, the extension of group of connected clients to further counterparts could produce an additional effect on RWA: groups of connected clients with revenues below 50 million take a "discount" on PD to a single counterpart for the calculation of RWA (article 153.4 of the CRR). So, the change of definition could bring some groups to cross the 50 million revenues threshold, thus causing the exclusion from the applications of "discounted PD". This would result in a further "RWA growth" effect in addition to the one cited above.

Similar to retail exposures these SME related capital treatments exist to reflect the fact that SME portfolios are made up of a larger number of smaller exposures and so benefit from a degree of diversification. In the same way as retail exposures, SME obligors default for a very wide variety of reasons and there is no evidence to suggest that failure by reason of the financial difficulty of entities on which they may be economically dependent is so predominant as to warrant a specific treatment to remove these treatments and treat them as, in effect, possessing no diversification benefit whatsoever. The LE framework deliberately assumes a conservative worst case view of grouping so as to constrain absolute maximum exposure, but this is not the right tool to consider the likely economic performance of a portfolio – which is in effect what the pillar 1 capital treatments are trying to do. We strongly urge that matters of risk concentration continue to be dealt with through pillar 2 rather than being reflected in pillar 1.

Specification of reporting requirements

Question 5: Please explain how the application of the draft guidelines on connected clients would possibly change current practices regarding the reporting to competent authorities, for instance in the area of liquidity?

In respect of reporting requirements, there will be operational issues to obtain the information required, because the liquidity databases containing data on counterparties are not designed to meet contemplated change to "Connected clients" in the sense that is outlined. This would require significant efforts in time and cost due to the application of economic dependence per the draft guidelines. As such, we are unable to provide an accurate estimation of potential impacts on metrics due to the extension of application, but note expected implications on current practices below:

- LCR & NSFR: change in the type / bucketing of some counterparties if they are included in the same group of connected clients;
- ALMM Template 67: Concentration of funding by counterparty. Concentration ratios could increase if a counterparty is included in multiple groups of connected clients; and
- ALMM Template 71: Concentration of counterbalancing capacity by issuer. Concentration ratios could increase if a counterparty is in multiple groups of connected clients.

We believe it would be inappropriate to capture entities multiple times across multiple groups as liquidity can only be lost once.

Furthermore, we do not believe that connected clients concept as being currently developed based on credit risk management concepts is directly relevant for liquidity risk management and as such scope extension using consistency as a premise is not justified. This is particularly the case when considering that counterparties whose financial health may be intrinsically linked owing to economic relationship, may not exhibit the same propensity to withdraw deposits or other short-term investments in funding.

As such, liquidity needs reliance on its own bespoke framework for understanding and dealing with concentrations. The impact of this proposal would overlay the existing behavioural considerations that already exist within the regulation. For example, the CRR delegated act for liquidity (of 10/10/2014) already includes detailed requirements on outflows and materiality threshold E.g.

article 25 defines EUR 500,000 deposit balance across all accounts as an indicator when requiring higher outflow rates.

In addition to the reporting impact, the extension of the 2016 Guidelines will also have a ratio impact on LCR and NSFR. This is because Article 3 of the Delegated Act on LCR gives following definition:

> 'retail deposits' means a liability to a natural person or to an SME, where the SME would qualify for the retail exposure class under the standardised or IRB approaches for credit risk, or a liability to a company which is eligible for the treatment set out in Article 153(4) of Regulation (EU) No 575/2013, and where the aggregate deposits by such SME or company on a group basis do not exceed EUR 1 million;

As the retail exposure categorization for credit risk will be impacted by the application of the Guidelines, there will accordingly be an impact on LCR/NSFR reporting and related requirements. In addition to the issues noted in relation to the expansion of scope to retail and SME exposures, there will likely be an unwarranted decrease in liquidity ratios as retail exposures are aggregated with non-retail exposures and fall outside of the retail classification, thereby no longer attracting the appropriate retail deposits treatment.

In conclusion, as per our response to the Guidelines on Connected Clients consultation issues in July 2016, we have significant concerns regarding the assessment of economic dependence, both in terms of i) the legal, operational and systems limitations in implementing the guidelines, and ii) the volatility and variability it will bring into capital requirements. The impact on capital requirements and the additional burden on the rating and reporting frameworks are especially concerning and it is counter to the stated objective of regulators of reducing unwanted variability and increasing comparability. We therefore ask that finalised Guidelines on Connected Clients give due consideration to the concerns we have raised in this response and our initial response.

Kind Regards,

Director, Prudential Regulation

Sahir Akbar

APPENDIX

afme/ Finance for Europe

Consultation response

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

24 October 2016

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Banking Authority's (EBA's) consultation on Guidelines on Connected Clients under Article 4 (1) (39) of Regulation (EU) No 575/2013. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

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We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Overview/Executive Summary

AFME and its members support the overall aim of ensuring consistency and avoiding overlaps with regulations and guidelines that have been published subsequent to the original 2009 CEBS Guidelines in relation to the issue of connected clients. However, we believe that a number of the proposals within the consultation go beyond creating consistency and avoiding overlaps to introducing additional expectations which require further clarification and in some instances go beyond the stated intent of capturing 'single risk'.

Regarding the assessment of economic dependency, we have noted that the requirement to form a group of connected clients has changed to instances when failure of a client would lead to 'repayment difficulties' from the 2009 CEBS Guideline expectation of 'substantial, existence-threatening repayment difficulties'. It would be helpful to provide a more precise definition of 'repayment difficulties' and to closely link its definition to the event of default; we believe this should mean repayment difficulties where the default of the counterparty is highly probable. This definition will ensure that connections captured are meaningful for the purposes of capturing 'single risk' and the framework remains aligned with the rationale of the Basel Committee, which specifically designed the large exposures framework to protect banks from large losses resulting from the sudden <u>default</u> of a single counterparty.

In the process of identifying economic dependencies and as recognised in the Guidelines, it will rarely be possible to implement automated procedures. The process for identifying connected clients is operationally complex, in particular where connections are vis-à-vis parties that are not an institution's clients (indirect counterparties). In addition to the practical difficulties in identifying such dependencies, this will have material cost implications for institutions and we ask that the requirement to identify economic dependencies not be extended to beyond an institution's client base. The cost implication is amplified in relation to investigating potential economic dependencies of entities / parties that are not part of an institution's existing client base as attaining the information will be more difficult and the costs associated with building IT systems and storage capacity for this information will be significant.

The cost would be particularly high for investigating and maintaining information regarding non clients. There is also a significant risk of imperfect linkages where non clients are concerned, as firms do not have access to an active dialogue with the party concerned to confirm the suspected relationships. It must also be recognised that sourcing this information will have impacts on customers, who will be required to furnish firms with considerably more information regarding their customers and suppliers to allow robust identification and are in our view not commensurate with the purpose of the large exposure regime; the large exposures regime is to 'set prudent limits to a single borrower or a closely related group of borrowers'[3] and thus limits its focus to counterparties (clients) and groups of connected counterparties of the institution and not beyond. If this requirement remains however, we believe the statement 'Institutions shall take reasonable steps[4] to acquire this information.' as well as 'that it must be in a position to demonstrate…its process is commensurate to its business' are key as it will allow firms to develop proportionate approaches for investigating connections via indirect counterparts.

Additionally, we believe the Guidelines would benefit from clarity in the area of situations for identifying economic dependencies. In particular, we believe it should be made clear that the situations are not intended as requirements i.e. there is no requirement to investigate each situation, but the situations are intended as useful items for consideration and reasonable efforts should be made to consider the situations where considered relevant and where the information necessary to make a robust determination is available to the firm.

Finally, we note that the 2% of eligible capital threshold for intensive investigation of potential economic connections remains inconsistent with the 5% of Tier 1 capital threshold recommended by Basel. The asymmetric compliance burden versus those that have adopted the 5% threshold, which will increase with the proposed change in threshold from 2% of own funds to 2% of eligible capital, creates a competitive imbalance and harms the level playing field between European banks and banks from other jurisdictions. In addition, the 2% trigger seems to be unnecessarily restrictive, potentially leading to the establishment of non-significant groups of connected clients and increasing banks' efforts without meaningful prudential benefits. Therefore, this threshold should be reconsidered as part of these revisions.

[3] http://www.bis.org/publ/bcbs283.pdf - Paragraph 2

[4] 'Reasonable steps' is understood to mean firms will use all existing information held by the institution and gained through regular customer file reviews per the firm's existing review cycle to identify economic dependencies, as well as investigate for additional economic dependencies where there is new information to suggest the existence of previously unidentified economic dependencies.

Questions

Group of Connected Clients based on control

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

There are instances where the existence of a control relationship among clients does not lead to a 'single risk', mostly relating directly or indirectly to the public sector and to Private Equity and Real Estate Funds. We believe these should be exempted from the requirement to record these connections for the purposes of identifying connected clients and have outlined our reasoning below.

Paragraph 37, 2009 CEBS Guidelines on the implementation of the revised large exposures regime states, in relation to clients that are connected by the central government, that there is no requirement to group these clients because "even though the owner has control over each entity, the risk connected with the exposure to one entity is normally not related to the risk of the exposures to other entities. In addition, the failure of one entity, which is a separate legal person, does not necessarily impose a duty on the owner to invest more capital" (Paragraph 37, 2009 CEBs). This logic applies to companies owned by the same private equity funds if some conditions are met. These conditions are the following:

- Non-recourse financing
- Secured financing structure to avoid any negative support and allow the bank to take the control of the entity in case of problem.

In our view, the treatment of companies owned by private equity funds justifies the application of the exemption from the requirement to group clients in relation to "control".

This logic can apply more generally to situations where the ownership relationship between a company and companies in which it holds participations, even controlling participations, does not necessarily create a default correlation and is therefore not a reason to create a connection. Investment holdings would fall in this category. Fund managers, for instance, may have investment holdings across a number of portfolios which in aggregate constitutes a majority holding. However, control of the fund manager is not unfettered (and not control in the CRR sense) as it must meet the fund objectives and is monitored by the Custodian[5]. Note, FASB and IASB do not require consolidation of 'controlled' entities in which a private equity (PE) firm has investment holdings as it recognises the limits to how control is exercised and the PE model being based on investment income and capital appreciation, rather than access to the investees' assets or liabilities.

Similarly, in project finance transactions structured with limited recourse and a full security package, the project company does not have to be connected to its shareholder or shareholders because the purpose of the financing structure is to finance the project on its own merits without recourse to its shareholders. Finally, in some asset finance transactions, the connection with third parties such as charterers for shipping transactions or lessees for real estate and aircraft transactions may be more relevant than the connection with the shareholders of the company owning the asset.

Note that in these various cases, consistent with this logic, the default probability assigned to these entities (LBO companies, project finance companies, asset finance funding vehicles) does not incorporate any support from shareholders. Risk parameters therefore reflect the absence of default correlation and connection between these entities and their shareholders.

In this respect, it is worth noting that IFRS 10 requires the consolidation of certain SPVs and therefore the risk of repayment difficulties has already been internalized by the consolidating

[5] See Annex for scenarios highlighting how instances of fund management control should be interpreted.

institution in these instances. As such, it would be inappropriate to capture these as connected clients for the purpose of capturing 'single risk' as the risk has already been captured. Additionally, where the SPV is established for securitization purposes, if there was a risk relationship it would only be with the debtors of the underlying assets, without the need to map the connection with the vehicle.

Under the current RTS on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets, banks have already taken all the reasonable steps to look-through to the underlying assets and to identify the obligors of all credit risk exposures underlying the transaction. Even where the underlying obligors cannot be identified, the exposures are to be aggregated into a single hypothetical 'unknown client' and the large exposures limit applied to the 'unknown client' in the same way it applies to any other single client. Thus, the 'control relationship' criterion appears irrelevant in view of this type of risk positions (transactions with underlying assets).

In practice, another very important defining feature common to many SPE is the bankruptcy remoteness. By construction, such ring-fenced characteristics mean an SPE's assets are isolated from any originators or creditors of its sponsoring firm should the latter go into bankruptcy, even though the accounting rules could require the relationship to be deemed 'controlling'.

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 likely impact will depend on the level of documentation required. Paragraph 12 of the Draft Guidelines states that institutions recognising an exceptional case 'should document the relevant circumstances which justify this case in a detailed and comprehensible manner'.

AFME suggests that EBA should specifically state that 'detailed' should be interpreted as being proportional to the risk posed. An absolute statement on what is meant by 'detailed' could have significant cost implications.

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.

No, we believe this to be clear.

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?

No, we view the existing indicators as very prescriptive and do not believe the inclusion of additional indicators is warranted or necessary. We would, in fact, favour an approach for identifying client interconnectedness which is based on auditable principles or policies for monitoring control relationships and similarly for economic dependencies.

afme/ Finance for Europe

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?

Firstly, we appreciate your consideration of feedback from institutions in this area and welcome the recognition of consolidated accounts as a source to establish control relationships.

In respect of instances of control relationships excluded from consolidated reporting requirements by way of exemption, the expectation that these control relationships are captured should be limited to instances where the financial statements or other official documentation (e.g. public registries) make mention of such relationships. In addition, it should be explicitly recognised in the guidance that reasonable efforts should be made in capturing these relationships and that further investigation to identify relationships is not expected other than brought to light through the normal course of business.

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

The statement in the 2009 CEBs guidelines on exposures to central governments (paragraph 37) is still deemed relevant. In particular:

'the risk connected with the exposure to one entity is normally not related to the risk of the exposures to other entities. In addition, the failure of one entity, which is a separate legal person, does not necessarily impose a duty on the owner to invest more capital. If the owner still decides to do so, it is assumed that this ultimately could be financed by raising revenues.'

As such, the existing treatment of central governments per Article 4(1)(39) of the CRR should continue. The inclusion of exposures to Central Governments into groups of connected clients is unwarranted from a risk management perspective, as is recognised through the exemption of exposures to Central Governments from large exposure limits under Article 400(1) and would make the reporting unduly burdensome.

Establishing interconnectedness based on Economic dependency

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.

The 2009 CEBS Guidelines established that there was no requirement to consider clients to be interconnected as long as an institution concluded that the failure of a client would not lead to "substantial, existence-threatening repayment difficulties" of another client. However, the draft guidelines propose to delete the expression "'substantial, existence-threatening" and simply retaining "repayment difficulties". We understand the EBA's intent to achieve a more prudent approach in this area; nevertheless, repayment difficulties should be linked to the intention of the Basel Committee to only capture connections that threaten default.

The Basel Committee's intent is clearly outlined in the BCBS's Standards on 'Supervisory framework for measuring and controlling large exposures'[6] in Paragraphs 1 and 3:

> Paragraph 1 *(except)*: 'Large exposures regulation has been developed as a tool for limiting the maximum loss a bank could face in the event of a **sudden counterparty failure** to a level that does not endanger the bank's solvency.'; and

[6] http://www.bis.org/publ/bcbs283.pdf

Paragraph 3 *(except)*: 'A large exposures framework complements the Committee's risk-based capital standard because the latter is not designed specifically to protect banks from large losses resulting from the **sudden default** of a single counterparty.'

Furthermore, Paragraph 27 makes it clear that if a counterpart can 'overcome financial difficulties, or even the second counterparty's default, by finding alternative business partners or funding sources within an appropriate time, the bank does not need to combine these counterparts to form a group of connected counterparties.' Thus, the connection is only meaningful to the extent it threatens default.

We recommend, therefore, defining repayment difficulties to be where default of the counterparty is highly probable, which would help ensure dependencies identified are meaningful for the purpose of capturing 'single risk' and limiting loss in the event of a sudden default of a counterparty.

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)?

We believe the situations are helpful for reference purposes, but that it should be made clear that these situations are listed for the purpose of helpful items for consideration, rather than there being a requirement to assess each situation for each possible connection. Reasonable efforts should be made to consider such situations where deemed relevant, but a requirement to assess each situation would result in significant IT investment costs, including costs for storing the relevant information. This is because the requirement will necessitate that banks aggregate information from each of its customer's 'know your customer' databases. Noting that customers may be other internationally active institutions with large customer bases, investigating and maintaining robust information regarding non client related connection information and storing it would be impractical and prohibitive. There is also a cost to customers in that firms will consider themselves compelled to seek very granular information from them regarding their supplier and customer bases in order to properly identify non client entities, which we do not feel is appropriate for the large exposure regime; the large exposures regime is to 'set prudent limits to a single borrower or a closely related group of borrowers'[7] and thus limits its focus to counterparties (clients) and groups of connected counterparties of the institution and not beyond.

Comments on individual situations:

The inclusion of situation 'h' that identifies clients that 'have an identical customer base, consisting of a very small number of customer and where the potential for finding new customers is limited' could lead to whole geographies or sectors being considered a single risk. It is clear from the CRR that these risks fall outside the scope of the large exposures regime as recognised in the consultation paper:

'Geographical and sectoral concentration risks fall outside the scope of the large exposures regime as provided for in Part Four of Regulation (EU) No 575/2013 and are addressed by other means such as the risk management rules on concentration risk under Pillar 2 of the CRD IV'.

We ask that this statement from the consultation paper should be included in the guidelines and believe situation 'h' should be removed from the list or replaced with one that clearly defines what is meant by 'a very small number of customers'.

In relation to situation 'i', we believe it would benefit from specifying a materiality level at which the common shareholding becomes relevant for the purpose of an economic dependency. For instance,

[7] http://www.bis.org/publ/bcbs283.pdf - Paragraph 2

two entities which have common shareholders but for which the shareholders interest only constitutes a minority holding in each entity, would not create an economic dependence whereby the failure of one entity results in a high probability of the default of the other. Our previous point on the requirement to treat investment by funds differently also applies in this instance.

Additional guidance would be welcome in relation to indicator 'j' to make clear what aspect of the relationship is important from an economic dependence perspective i.e. the significance of the loan to both parties.

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.

The explanatory box gave the example of a situation where institutions have exposures to a number of unrelated counterparties, but which are all guaranteed by the same guarantor, even if the individual exposures are not significant enough for the guarantor to be likely to default or experience financial difficulties if a claim occurs.

This example is in contravention to a number of aspects of the large exposures regime. In this example the connection goes beyond the existing 2009 CEBS guidelines of 'substantial, existence threatening repayment difficulties' as well as the more prudent 'repayment difficulties' guidelines proposed in the revisions. In addition, it de-couples the concept of economic dependency constituting a single risk, to indirect contingent dependencies. As such, the scenarios should remain focussed on first order impacts from direct and material dependencies.

Article 403 makes clear that firms are entitled to ignore the existence of guarantees for the calculation of large exposures. It is in our view beyond the remit of the EBA to overrule Level 1 text, which it would do if the mere existence of a guarantor creates a connection.

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.

The concept is clear even if its application is not straightforward, as the assessment of the economic dependency is often not clear-cut because of the high degree of subjectivity and the lack of relevant and definitive information; this has the consequence of 'volatile' reporting of groups' exposures in the LE framework due to the changes in the groups perimeter.

<u>Other Matters</u>

Reasonable Steps

Notwithstanding the matters noted above, it is near impossible to ensure completeness of data and further still, interconnections are likely to change faster than the reporting frequency of data on which banks would be reliant to maintain records. As such, AFME was pleased there was recognition that 'as the determination of economic interconnections is dependent on the one hand on the **information available** to, or gathered on a **<u>best efforts basis</u>** by the reporting institution, and on the other hand on **<u>economic judgement,</u>** it is possible that **<u>different institutions will arrive at different results when analysing the same entities</u>**.' We note the reference to best efforts basis here and the reference to the 'reasonable steps to acquire this information' elsewhere in the paper. As such, we ask the wording is aligned to say 'or gathered on a reasonable efforts basis by the reporting institution'. Best efforts has cost implications as it suggests a materiality threshold for investigation cannot be applied, rather than the intent for processes to be commensurate to the business.

Economic dependency through a main source of funding

We note that there are no changes in the 'Economic dependency through a main source of funding' section of the guidelines. We understand this to mean there is no expectation for institutions to change the way in which they currently comply with the guidelines, particularly as some national authorities have provided detailed guidelines on how to comply with the expectations in this area previously (particularly in regard to the treatment of own firm SPVs).

Explanatory diagrams

As discussed at the EBA Hearing, the diagrams included in the Consultation Paper are viewed as helpful and we ask that these are included within the final Guidelines.

Kind Regards,

Director, Prudential Regulation

Sahir Akbar

Annex

All of the scenarios below are to some extent variations on how instances of fund management control should be interpreted.

1. Loan to a CRR regulated Fund Manager or a fund manager under UCITS or AIFD

Some of the large exposure questions this raises are:
- Is this effective "control" intended to be captured by the CRR definition?
- Even if this is not "control", is this considered economic risk, for example from a funding perspective?
- What would the impact be for banks, and the fund management industry, if long-standing approaches were changed to bring such situations into the large exposure regime?

Industry seeks confirmation from the EBA and European Commission that there is no intention of changing long-term practices. A change would have detrimental effects on the asset management industry and create significant regulatory burdens for lenders. The burden is that fund managers will not (and indeed should not for conduct reasons) disclose to their bank the totality of their investments – which would be required for banks to be able to meet the new requirements if such situations are not exempted. We would expect that an aggressive interpretation would mean a significant increase in risk of asset managers, as they will no longer be willing (or able) to rely on banks for their corporate liquidity management.

The situation of a loan to an AIFD fund manager is discussed under 5 below.

The rationale for the exemption is that:
- Fund managers do not have unfettered control.
- There is no single risk, as the underlying companies are not interconnected
- Even in case of default of an underlying exposure, the financial stability of the fund manager is unaffected due to diversification in the breadth of portfolios.

2. Loan to a company where a fund manager (such as AAM) could be seen as "controller" under an aggressive interpretation of the new proposals.

This scenario raises similar questions to the ones under 1.:
- Does this effective "control" by the fund manager mean that a bank would have to go up to the fund manager and down again to all other entities that it may control via its funds in order to meet its obligations under the large exposure requirements?
- Even if this is not "control", is this considered economic risk, for example from a funding perspective?
- What would the impact be for banks, and the fund management industry, if long-standing approaches were changed to bring such situations into the large exposure regime?

Industry seeks confirmation from the EBA and European Commission that there is no intention of changing long-term practices of not including these into the scope of large exposure management. A change would have significant detrimental effect on the industry financing and future economic development. The burden this would require of banks to demonstrate that they have understood all connections at fund managers will not (and indeed should not for conduct reasons) disclose to their bank the totality of their investments – which would be required for banks to be able to meet the new requirements if such situations are not exempted.

The rationale for the exemption is that:

- Fund managers do not have unfettered control.
- There is no single risk, as the underlying companies are not interconnected. There is therefore no risk of contagion.
- Even in case of default of an underlying exposure, the financial stability of the fund manager is unaffected due to diversification in the breadth of portfolios.

3. Loan to a company which is ultimately controlled by a venture capital or private equity firm (jointly called "private equity firms" hereafter).

This section is intended to discuss a situation where a venture capital or private equity firm owns more than 50% of the borrower, either directly or indirectly through a fund in which it co-invests. The example should be viewed slightly differently to the one in section 2, given that generally the business of private equity firms is to have more of an influence on the activities of the companies they invest or co-invest in. Nevertheless accounting standard setters have acknowledged that this is different to a typical parent - subsidiary relationship and have therefore exempted these arrangements from consolidation requirements.

The key considerations are:

- FASB and IASB do not require consolidation of such controlled entities in recognition of the limits to how control is exercised. Is recognition of this approach for large exposure regime acceptable?
- The exemption from consolidation also reflects the lack of single risk. Thus a default of an investee company would not create any contagion to either: the private equity firm, the fund through which it and other investors invest, or other investee companies[8]. There should therefore be no aggregation for large exposure purposes.
- What would the impact be for banks, and the private equity fund management industry, if long-standing approaches were changed to bring such situations into the large exposure regime?

Industry seeks confirmation from the EBA and European Commission that there is no intention of changing long-term practices of not including these into the scope of large exposure management. A change would have significant detrimental effect on the industry financing and future economic development. The burden this would require of banks to demonstrate that they have understood all connections at private equity firms will not (and indeed should not for conduct reasons) disclose to their bank the totality of their investments – which would be required for banks to be able to meet the new requirements if such situations are not exempted.

The rationale for the exemption is that:

- Private equity firms do not have access to investee's assets and liabilities.
- There is no single risk, as the underlying companies are not interconnected. There is therefore no risk of contagion.

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[8] This is based on the general approach in the private equity industry that it does not downstream debt into equity. The situation would be different if the private equity firm received loans that it down-streamed to the investee's company as either debt or equity.

- Even in case of default of an underlying exposure, the financial stability of the private equity firms is unaffected due to diversification in the breadth of portfolios.

4. Loan to a fund (private equity fund or other)

Investments into funds have specific capital requirements under CRR and require look-through for large exposure purposes. The situation is less clear where the exposure is of a different type, such as a loan or counterparty credit risk as a result of a derivative contract with the fund. Such exposures do not impact on the value of the fund's underlying investments and are attributable to the investors in the fund, not the investee companies. As a result it is the industry's view is that

Such a loan to a private equity firm would fall under a shadow banking exposure on the basis that it could be down-streamed to investee companies and therefore represent shadow banking activities. The industry notes that it would only lend to a private equity firm to facilitate its liquidity management, as opposed to enabling leverage of the private equity firm.

Under such circumstances, where there is no leverage brought into the system by lending to a fund it is the industry seeks confirmation that:

- Banks can treat such exposures as a single exposure not requiring look through.
- Banks do not have to look up to investor entities (and particularly not down again) to meet the large exposure requirements.

It has already been noted under 2) that no large exposure aggregation should arise to the fund manager in case the fund manager is acting solely in its capacity as fund manager.

5. Other

These Guidelines do not reference treatment of exposures to trusts. Some national authorities have created specific expectations for these exposures[9]. These expectations are not contradictory to the Guidelines proposed in this consultation, but are instead more prescriptive. As such, we understand the intention is not to change the expectations in these instances and existing treatments should be maintained to comply with local expectations / law.

[9] Section 23 of Italian Banking Law, Article 2359, Paragraphs 1 and 2, relate to the issue of control and indirect control through trusts.
Section 5 of the PRA's Supervisory Statement on Large Exposures also covers expectations related to 'Exposures to Trustees':
http://www.bankofengland.co.uk/pra/Documents/publications/ss/2013/ss1613.pdf