[Final draft]

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EBF response to EBA consultation on the scope of the draft guidelines on connected clients under Article 4 (1) (39) of Regulation (EU) No 575/2013

Key points:

- The EBF recognizes that consistency must be improved with regard to the mapping of groups of connected clients among entities and across the whole CRR.
- Notwithstanding this, the issues that the EBF raised with respect to the draft EBA guidelines on the definition of connected clients[1] would still apply and even be magnified since the scope of the guidelines is now wider. The EBF is of the opinion that the proposed assessment of connections between clients must be changed if the scope should be extended.
- The application of the connected client framework to the proposed extended scope could impact the retail classification and increase the risk weighted assets of banks since exposures could breach more easily the EUR 1 million threshold below which they can be classified as retail. It should be assured that for retail clients banks should not have to undertake additional analysis for the purposes of connected clients in addition to existing analysis.
- The impacts of the application of the draft guidelines on connected clients to rating systems could be significant since the rating systems would now have to take into account the relationships between exposures. The guidelines on the definition of the concept of group of connected clients would also affect the identification process of default.
- The application of the guidelines to the current practices regarding the use of the SME supporting factor would imply an increase of the risk weighted assets of banks. Indeed, SME exposures would more easily breach the EUR 1,5 million threshold below which the SME supporting factor can be applied. All in all, the effectiveness of the SME supporting factor could be jeopardized.
- The scope of the definition of connected clients should not be extended to the liability side of the balance sheet, as it would unduly affect the liquidity ratios.

[1] See the EBF response "*EBF Response to EBA consultation paper on Guidelines on Connected Clients (EBA/CP/2016/09)*".

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EBF position:

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

   Please specify what overall impact the extended scope would have. If relevant, please differentiate between the impact of considering connected clients due to control or connected clients due to economic dependencies

The EBF recognizes that consistency must be improved with regard to the mapping of groups of connected clients among entities and across the whole CRR, and welcomes the efforts made by EBA in this sense.

Notwithstanding this, it is worth noting that the proposed definition of connected clients is quite complex and raises significant concerns.

The issues that the EBF raised with respect to the draft EBA guidelines on the definition of connected clients[2] would still apply and even be magnified since the scope of the guidelines is now wider. It has to be noted that the actual impact of the expanded scope of the Guidelines would vary significantly depending on the final version of these draft guidelines which has still not been published. Anyway, the EBF is of the opinion that the proposed assessment of connections between clients must be changed if the scope should be extended.

- A broader application of the economic dependency criteria would involve a significant operational effort by banks as the number of groups of connected clients may increase substantially. Clear instructions and definitions which are operationally manageable are needed.
- In accordance with the purpose, when establishing a group of connected clients, only clients which are assessed to in fact constitute a single risk should form a group of connected clients. Thus, when assessing interconnectedness based on control relationship and/or economic dependency, actual substantiality and material impact on credit risk in the individual case is to be considered.
- We do not support tying economic dependency to the existence of general financial difficulties irrespective of their duration and how serious their consequences are for the lending institution.
- The EBA's proposal to reduce the threshold to 2% of the eligible capital which triggers the investigation of potential economic connections would override the Basel framework jeopardising the level playing field. The 5% level is already a conservative threshold as long as large exposures are defined as those which overcome the 10% of bank's eligible capital. We do not see the rationale for applying any other level than the 5% ensuring alignment with the Basel framework.

[2] See the EBF response "*EBF Response to EBA consultation paper on Guidelines on Connected Clients (EBA/CP/2016/09)*".

- Moreover, such an important change, changing the threshold from 5% to 2%, should not be implemented via an EBA guideline but should rather be done through a revision of the level one regulation. The threshold is an essential element and should be interlinked with the European Commission potential revision of possible restrictions in the definition of eligible capital definitions.
- Interconnectedness through control differs fundamentally from interconnectedness through economic dependency. Any obligation to link these in a prescriptive and mechanical manner may lead to unintended outcomes and far-reaching requirements for the formation of groups of connected clients. We are opposed to such an approach as currently proposed, as this would go beyond the requirements set in Article 4 (1) (39) b) of the CRR, however we recognise that where there is a clear risk of a default of an obligor through their economic connection leading to high and material likelihood of default of the counterparty it should be recognised and included in a large exposure assessment, based on analysis of the individual case by the relevant analyst

The first effects are on the perimeter of the group of connected clients:

- main groups of connected clients becoming even bigger, if requirements for forming a group of connected clients due to economic dependency are tightened.
- we expect more volatile group boundaries (given also that the inclusion of these additional entities is based on conditions that are not easy to ascertain and on discretionary requisites).

Relationship with the customers would likely need to be reshaped as additional information, potentially falling in the insider area, would need to be retrieved directly from the customers.

It is noteworthy that while public information is available on large corporates, it is in general not the case for retail clients. Thus, institutions should not be required to undertake a thorough analysis of retail clients. However, if it is known to the institution that a client belongs to a group of connected clients, this should be taken into account for other areas of the CRR that deal with the concept of GCC.

Moreover, banks would need to update their processes and procedures in order to retrieve, store and elaborate the new flow of information. There are also concerns about maintaining the information up to date. This would require significant investments. In that vein, the EBF recommends the EBA to perform a quantitative cost/benefit analysis in order to assess the costly required IT changes.

More generally, in light of all the above, EBF recommends a thorough assessment of the economic impacts of the proposal.

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

   What is the likely impact of applying the draft guidelines on connected clients to the categorisation of clients in the retail exposure class (Article 123(c) and Article 147(5)(a)(ii) of the CRR)?

   If there is an impact, please provide concrete examples and both qualitative and quantitative information, specifying whether the impact is related to the Standardised Approach or the IRB Approach for credit risk

As explained in the response to Q1, the application of the connected client framework to large corporates raise several concerns and has to be assessed on a case by case basis. Applying the same framework to retail clients is even less appropriate. Although its application to retail clients is required by the CRR, the concept of connected clients such as defined by the draft EBA guidelines makes sense for entities but less for physical persons.

Should the revised concept of economic dependency be applied to private individuals implying their inclusion in an economic group in a more extended way than it is today, a shift might occur from the retail to the SME or other assets classes, therefore creating a likely and unwarranted increase in risk weighted assets.

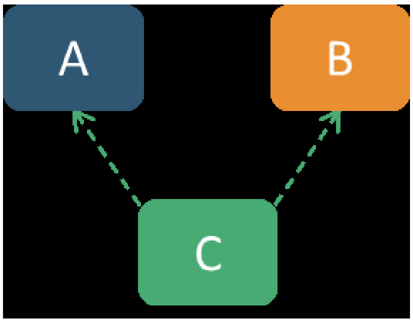
Thus we recommend that natural persons are excluded from the scope of application of these guidelines with the exception of specific categories such as shareholders and top executives.

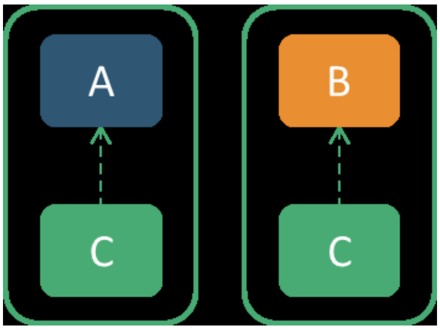
In addition to the fact that information for retail clients would not be readily available, it must also be noted that it will be difficult to maintain the information up-to-date. The EBA must precise the frequency of the required updates.

The application of the connected client framework to the proposed extended scope would impact the retail classification and increase the risk weighted assets of banks. Retail exposures, in particular SME exposures would more easily breach the EUR 1 million threshold to be classified into the retail category. For example, an exposure to a small supplier below EUR 1 million could no longer be classified in the retail category if this supplier is considered to be connected to a large corporate. In this case, the 75% risk weight for retail exposures could not be applied anymore and the exposure would be assigned with a higher risk weight for Pillar 1 purposes. It is noteworthy that the 75% risk weighted associated to retail exposures is justified by the diversification effect on a portfolio level. Indeed, on a portfolio level, it is very unlikely that all the retail exposures get into difficulties simultaneously, which justifies the application of a lower risk weight than the ones that applies for corporates.

It is also worth mentioning that the quantification of the impact of the application of the framework is not possible either under IRB or STA due to the difficulties of getting the data on retail clients.

Finally, the proposal would create some overlapping of connected clients. In the following example, C is economically dependent from A and B (with no connection between A and B). According to the Guidelines, 2 groups of "connected clients" should be formed (A+C and B+C)





The possibility that counterparties could be mapped in more than one group of connected clients would lead to an unjustified multiple counting of banks' exposures. Besides the operational complexity of the proposed assessment which would require an additional and burdensome investigation of economic relations, this double counting seems unduly penalising. Some specification should be introduced in the guidelines to avoid the double counting of exposures.

This issue will raise significant concerns with regard to the categorisation of retail and corporate exposures. Indeed, if the proposal is applied as such, the very same client could be included in a group of connected clients that should be deemed as non-retail and at the same time in a group that should considered as retail. In thise case, it is not clear how capital requirements must be calculated.

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)?*

The EBF does not 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. Although the CRR establishes that each counterparties will still be assigned with its own rating, this would now have to consider the connections with other clients such as defined by EBA In its draft guidelines which may have significant impacts. The rating systems would now have to take into account several issues that remain out of the control of the entity but that will depend on its judgement and its capacities to identify the relationships between exposures. All in all, the new framework would add complexity and heterogeneity in its application.

Current practices take into account the existence of connection based on economic dependencies on a case by case basis with expert analysis (or in a semi-automatic approach) for both rating analysis and default definition. The monitoring of connected clients according the definition proposed by EBA in its draft guidelines in the IT systems would be unduly burdensome with no significant improvement in the results of the risk profile assessment.

More specifically, the inclusion of economic connections based on "*repayment difficulties*" in the policies for the treatment of groups, as required by Article 172(1)(d) of the CRR, would have a material impact on the credit risk modelling.

The proper inclusion of the information on economic connections among clients for rating assignment is conditioned to the capacity of including a congruous improvement of the risk differentiation performance. The "*repayment difficulties*" concept has a weaker and less clear relation with the default events, thus the extension of the economic link mapping by applying such approach would limit the discriminatory power contribution stemming from the information on the existence of an economic link.

As far as the application of the rating systems is concerned, the "group effect" considered in the counterparty rating assessment would be extended to a larger number of entities - included in the group perimeter due to a modified definition of economic connection - embedding the potential shortcomings concerning the risk differentiation power of the group link information.

Thus, the potential impact might be twofold:

- appropriateness of rating assignment on the single obligor and of the applicable pricing
- extension of the rating assignment perimeter embedding the group link function to broad set of obligors.

The proposal also affects the implementation of the EBA Guidelines on the definition of default[3].

As specified in Paragraph 61, connected clients approach should be considered in the identification of default. At the same time, the identification of default drives the definition of the target variables for developing and calibrating the models.

In addition, the policies for the identification of default contagion effect should be in line with the assignment of obligors to obligor grades[4]. Were the "*repayment difficulties*" criterion applied, in case of default of one member of the group, the need for assessing the potential "unlikeliness to pay" might be extended to a much broader perimeter of clients, with potential consequences on the accuracy of the analysis.

Also for the purposes of Article 172(1)(d) of the CRR and EBA Guidelines on the definition of default, it is therefore deemed important to keep the concept of "single risk" definition more anchored to the current approach based on "*substantial, existence threatening repayment difficulties*".

The rating systems will need to be developed and adapted to include all the information required to implement the new framework.

Banks would probably keep individual ratings for internal risk assessment, which would increase the gap between with the standardised approach.

[3] *Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013.*

[4] *"In particular institutions should specify in their internal policies when the default of one obligor within the group of connected clients has a contagious effect on other entities within this group. Such specifications should be in line with the appropriate policies for the assignment of exposures to individual obligor to an obligor grade and to groups of connected clients in accordance with point (d) of Article 172(1) of Regulation (EU) No 575/2013".*
"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.".

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?*

   What is the likely impact of applying the draft guidelines on connected clients to the SME supporting factor (Article 501(2)(c) of the CRR)? If there is an impact, please provide concrete examples and both qualitative and quantitative information.

Similarly as the consequences of the application of the framework to the classification of retail exposures explained in Q2, the application of the guidelines to the current practices regarding the use of the SME supporting factor could imply an increase of the risk weighted assets of banks.

Indeed, SME exposures would more easily breach the EUR 1,5 million threshold below which the SME supporting factor can be applied. For example, an exposure to a small supplier below EUR 1,5 million would not benefit anymore from the SME supporting factor and thus from the associated reduction in the required risk weighted assets if this supplier is considered to be connected to other SMEs or corporates. In this case, the exposure would be assigned with a higher risk weight for Pillar 1 purposes. Moreover, it would imply significant changes in banks' internal models, at least those used for large corporate as this category would consequently cover a wider population, with new features. Those model changes being material, they would have to be addressed through the new ECB model validation process. It is also to be noted that, as the population covered by the modified models is to be less homogenous, the precision of the models would be of lesser quality.

It is noteworthy that the introduction of the SME supporting factor into the European Legislation is considered as an important element to promote financing to SMEs which are a key driver of economic growth and job creation. At this respect, in the context of the review of the CRR, the European Commission has even recently proposed the application of a supporting factor to the portion of the exposure exceeding € 1.5 million, although the capital reduction is lower for these exposures than for those that remain below the threshold.

The application of the guidelines to the current practices regarding the use of the SME supporting factor could jeopardize the effectiveness of the SME supporting factor since they would restrict the scope of application of this capital relief.

There will also be a problem to assess if the SME supporting factor is applicable or not when a client must be included in several group of connected clients. In this case, the calculation of SME supporting factor will be accordingly burdensome and complicated.

Finally, it is also worth mentioning that the application of the framework to the practices regarding the use of the SME supporting factor would also raise operational issues as explained in Q1 and Q2.

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?*

   What is the likely impact of applying the draft guidelines on connected clients to reporting requirements, where relevant? If there is an impact, please provide concrete examples and both qualitative and quantitative information For Members: Do you have any initial elements to elaborate the answer to question 5?

The application of the proposed connected client framework to reporting requirements would raises significant operational issues since the liquidity databases currently storing the data on counterparties are not designed in a way that would easily allow integrating the proposed definition of connected clients. In this sense, the application of the proposed framework to reporting requirements would entail significant efforts in time and costs.

The following implications of the adoption of the new framework in current practices are worth to be mentioned:

- LCR & NSFR: change in the type of some counterparties if they are included in a group of connected clients.
- ALMM Template 67: Concentration of funding by counterparty. The concentration ratios may increase if some counterparties are included in a group of connected clients.
- ALMM Template 71: Concentration of counterbalancing capacity by issuer. The concentration ratios may increase if some counterparties are included in a group of connected clients.

As explained before, it is also worth mentioning that the quantification of the impact of the application of the framework is not possible since it required data is not collected and available in the current context.

In addition, it is to say that the EBA draft guidelines on the definition of connected clients were initially aimed at the large exposure regime only. Consequently they were limited to clients to which a bank has granted a loan. If the scope of the guidelines is expanded to clients that only have deposits, it would mean that institutions would have to gather additional information that would not be available under the EBA draft guidelines. It is also less likely that costumers with deposits only would be willingly to provide such information. In this sense, the guidelines should not be extended to areas of liquidity.

Furthermore it should be noticed that some clients belong to several group of connected clients. For the large exposure regime this may be feasible. In case of the area of liquidity such multi-assignments are problematic. In case of ALMM this would lead to an overestimation of concentration risk on the refinancing site (C67.00).

In general the EBF opposes the idea of expanding the scope of connected clients to the liability side of the balance sheet. Such classifications do not exist at the moment in banks IT systems and building them up from the scratch will be a huge challenge. Costs-benefits analysis is needed, since benefits remain unclear while costs would be significant.

About EBF

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