



## EACB Comments

### EBA Draft Guidelines on the scope of the draft Guidelines on Connected Clients under Article 4(1)(39) CRR (EBA/CP/2017/07)

Brussels, 26<sup>th</sup> June 2017



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## **Introduction**

The members of the EACB welcome the opportunity to comment on the EBA draft Guidelines on scope of the definition of group of connected clients (GCC).

The EBA aims to extend the concept of connected clients particularly in two different contexts, large exposures and the categorisation of clients in the retail exposure class for credit risk. While in general the EBA approach to establish one universal rule-set regarding the applicable GCC definition and rules for identifying and reporting of GCC for the purpose of CRR seems to be a step into the direction of simplification and improved consistency it would also lead to potential issues, particularly for the retail segments if applied as proposed.

First, the proposed scope of application is not sufficiently clear. It is unclear whether all retail exposure classes or only certain parts of it would be affected. Moreover, the requirements for the identification of potential GCCs are not appropriate and proportionate for the retail segment where the number of potential counterparts is much higher, causing disproportionate efforts.

In addition, Recital 55 CRR indicates that the objective for the large exposure regime is to deal with single name concentration risk without applying any risk weights or the degree of risks. As the objectives of these two concepts differ significantly, the application of definitions or provisions designed for either of them to the other one should be subject to a legal endorsement process and a careful impact assessment. The same would apply to any extension of provisions within the large exposure concept to any other CRR areas.

The draft GL on the Connected Clients (EBA/CP/2016/09) also intended to apply to shadow banking entities (para. 28). However, for the purpose of shadow banking the EBA has already delivered its regulatory product with the GL on limits to shadow banking exposures under Art. 395(2) CRR. The mandate of the EBA to develop Guidelines for the limitation of exposures to shadow banking entities is restricted to the large exposure regime and an extension of this definition for credit risk purposes is not legally justified.

Lastly, the initial application efforts and successive administrative burden for institutions caused by the implementation of and regular compliance with the proposed Guidelines go much beyond any potential advantages for the financial sector or the economy.

## **Answers to specific questions**

Q1: 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.

### **Examples from practical applications**



Restricting the Connected Clients requirements (mainly economic dependency) to the Large Exposure regime is plausible since large exposures could pose a threat to an institution's continued operation as a going concern and is thus subject to a supervisory limit (concentration risk). Extending the scope to all clients does not respond to this purpose.

Interconnectedness by Control is already applied by some institutions including retail clients. However, the economic dependence of one client on another client must, for credit risk purposes, be placed in a broader perspective, including the assessment of the merit of credit, before providing funding. This may involve customers, suppliers, etc. A material economic dependency might affect the probability of default of this client by means of non-financial input in the scorecards and expert judgement.

Furthermore, this concept covers the (interconnectedness of) clients outside the institution and not only clients within one institution. Within the retail market, small businesses are more likely to depend on one larger supplier or customer. For instance franchise chains, transport enterprises or farmers (e.g. dairy). The criteria provided could even hint that these franchise chains may be seen as a single risk, causing enormous problems in terms of flows of funds. One should also wonder what would happen if one or a few of these franchisees, or the franchisor, is not a client of the institution or can change to another bank. Would the economic dependency risk then negligible?

We therefore question whether non-large exposures like for example retail and SME exposures increase idiosyncratic risk and therefore becomes a supervisory issue. Given the relative small exposures per client this should rather point to a well-diversified risk profile and therefore reduce idiosyncratic risk. Finally, the cost for institutions to upgrade their processes, IT systems and procedures is not outweighed by the unclear benefits of the proposed extension.

#### Design inconsistencies

Another main issue of concern lays in the fact that in the original draft the rules and data and process requirements towards identification of potential GCCs were designed and built with the idea that they will be applicable only to the 'Large exposures'. As such they stipulate a lot of individual and labour intensive steps required in the customer economic connections identification, credit exposure origination and the underwriting and regular monitoring process until the full repayment. For example, the draft Guidelines on Connected Clients states the following:

- ✓ "3.2.5 Control and management procedures in order to identify connected clients. 34. [...] The necessary inputs require utilising 'soft information' that typically exists at the level of individual loan officers and relationship managers. Institutions shall take reasonable steps to acquire this information."

We see that this is somehow feasible for a limited number of very big exposures to large GCCs. However, if transposed with no adjustments to Retail, where the number of different GCC and potential individual deals is incomparably higher, it would require much more additional human and system resources to attend such extensive data gathering on a case by case basis. At the same time it is referring to subjective and unclear "reasonable steps"



to acquire the information, leaving it open to various interpretations by the different institutions.

- ✓ "35. [...] Furthermore, institutions should also monitor for changes to interconnections, at least in the context of their periodic loan reviews and when substantial expansions of the loan are planned. [...] 36. It is important to note that institutions need to have information on all entities forming a 'chain of contagion' to be able to correctly identify groups of connected clients. If there are interconnections among group members the institution has no business relation with (and thus has not collected any information with regard to possible interconnections), the correct identification of a group of connected clients might not be possible. However, if an institution becomes aware of such interconnections via entities outside its clientele (e.g. by press statements), it needs to in-corporate this information in its grouping practice."

While this is partially feasible for limited number of SME exposures and GCCs having annual loan review process, if transposed unmodified to Retail it would affect also the natural persons where such standard annual review process is not part of the current STD or IRB process accepted by the regulators. If the scope regarding the pure Retail approach portfolios remains unclarified, the establishment of a regular annual review requirement on all Retail exposures would lead to a massive increase of the necessary human and system resources, not fitting the scale and the Retail process standards.

- ✓ "37. It will rarely be possible to implement automated procedures for identifying economic interconnections; therefore, case by case analysis and judgement should be used."

Such case by case analysis and judgement is inapplicable to the Retail world and the sheer amount of individual cases; other reasonable and balanced potential solution for Retail customers are needed where the usage of relevant internal and external automated registers data and internal algorithms to automatically establish GCC connections would be accepted as 'process is commensurate to its business'.

Q2: 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 recalled above, the proposal will have a decisive impact on processes and data and system/IT landscape. The categorization of retail exposures will be impacted as well. Retail exposures are treated/ managed in a different way compared to corporate exposures.

With reference to Art. 147(5), retail exposures shall meet the following criteria: (a) they shall be to one of the following, (i) exposures to one or more natural persons, (ii) exposures to an SME, provided in that case that the total amount owed to the institution and parent



undertakings and its subsidiaries, including any past due exposure, by the obligor client or group of connected clients, but excluding exposures secured on residential property collateral, shall not, to the knowledge of the institution, which shall have taken reasonable steps to confirm the situation, exceed EUR 1 million; (b) they are treated by the institution in its risk management consistently over time and in a similar manner; (c) they are not managed just as individually as exposures in the corporate exposure class; (d) they each represent one of a significant number of similarly managed exposures.

Corporate exposures are reviewed annually; retail exposures are reviewed in a bucketing approach. This is accompanied by corresponding capacity/staffing. To determine the quantitative impact, each individual (retail) client must be assessed, which seems a disproportionate and undue cost and effort.

Moreover, the text of chapter 2.3.1 is unclear. While in the title it refers to the general Retail exposure class, later in the paragraph it refers only to parts of it (Art. 123(c) and 147(5)(a)(ii) CRR). From our point of view, as already mentioned above, the requirements are not commensurate to natural persons. Currently, an asset class rules specific for 'excluding exposures fully and completely secured on residential property collateral' (Art. 123(c) CRR) for the purpose of the asset class segmentation is only provided for the Retail Private Individuals asset class and not for the other Retail asset class Micro SME. The requirements of the draft Guidelines would mean the necessity to introduce new asset segmentation rules.

Q3: 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)?

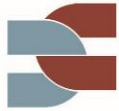
Since repayment difficulties of one client could lead to repayment difficulties of another client this implies that the probability of default of both clients are interconnected at least for the depending client. However, 'repayment difficulties' do not equate to 'default' and 'single risk' does not equate to 'the same probability of default'. However, this distinction is not clear. Additional clarifications would be needed.

Q4: 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.

We see that the proposed Guidelines would counteract the efforts undertaken by the Commission to strengthen the SME market through an extension of the SME supporting factor as proposed in the CRR Review.

The draft guidelines will impact the categorization of exposures (retail/corporate) and thus will impact the use of the SME support factor (EUR 1,5million). To determine the



quantitative impact, each individual (retail) client must be assessed, which seems a disproportionate amount of work and time when weighted against the risk.

Q5: 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.

Our Members indicate that the proposal will largely impact processes, data and system/IT landscape and will therefore require also a change into practices of reporting to the competent authorities. It is not feasible to provide currently a relative good approximation of the impact.