

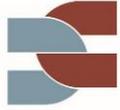


## EACB Comments

EBA draft GL on Connected Clients under Article  
4(1)(39) CRR

(EBA/CP/2016/09)

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## **Introduction**

The members of the EACB welcome the opportunity to comment on the EBA draft Guidelines (GL) on connected clients as defined in Article 4(1)(39) of the CRR.

According to the proposed guidelines, institutions should assess the existence of a group of connected clients (GCC) as defined in Article 4(1)(39) CRR based on the criteria described in the draft GL for the purpose of Part Four of the CRR, i.e. for Large Exposures (LE).

It remains thus unclear how institutions are expected to handle this assessment in cases not related to LE. It would be unfeasible to have different approaches and definitions of GCCs.

Indeed, CRR requires the use of GCC as defined in Art. 4(1)(39) CRR not only for LE: Art. 123 and 147 CRR require it for the definition of Retail segment in both SA and IRB Approaches, Art. 172(1)(d) for rating process and Art. 501 for SME supporting factor. It is not clear whether it should be assumed that such areas would not be subject to the draft guidelines.

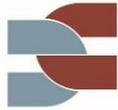
The GCC definition from Art. 4(1)(39) CRR is a concept firmly established in overall risk management processes. Established lending policies and credit application processes usually take into account the whole GCC and not each member separately. All GCC members are treated in the same portfolio of the respective business and risk management units who are consequently responsible for them throughout the lifetime of the GCC.

Therefore, we find it necessary to clearly define how the assessment of control relationship and economic dependency should be performed in general, and if there can be any differences between such assessments, depending on the purpose Art. 4(1)(39) CRR definition is used for.

Finally, we would point out that there is a clear need for a transitional period. As the new GL differ from the current set dating from 2009, EBA should consider a grandfathering period of at least 18 months from the date of publication of the final supervisory requirements. Institutions, or the service providers they employ, need sufficient time to prepare the required modifications of IT systems. Moreover they will have to evaluate every single counterparty on the differences between the old and new GL. It should be possible to carry out this review along with the regular routine of credit processes (taking into account necessary preliminary work such as elaborating the modifications, training the responsible staff etc).

## **General comments**

We believe that the current rules on groups of connected clients adequately ensure that the concentration risk resulting from a close legal or economic connection between borrowers is captured and limited. We therefore do not see the urgency of the review of the 2009 CEBS Guidelines, in particular given there is no clear mandate in CRR for this regulatory product. A stricter approach than current supervisory practices, as would



result through the tightening of the criteria for economic dependency and the new approach to the relation between control and economic dependency, would require an amendment of Art. 4(1) (39) CRR. We believe that more attention could rather be devoted on a uniform application of the existing rules.

We understand that EBA aims to finalise the draft GL in the first quarter of 2017 for an entry into force in the second or third quarter of 2017. Bearing in mind the ongoing revision of the European large exposures regime (CRR review, legislative proposal announced for the end of 2016), we believe that a review of the guidelines on connected clients does not make sense at this stage. The concrete implications of the EBA's proposals – particularly the extent to which there is a threat of large exposure limits being exceeded and lending capacity being restricted – and necessary changes cannot be reliably assessed at the moment. The ongoing consultation process should therefore await the outcome of the CRD IV/CRR review.

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

### **Answers to specific questions**

*Q.1 Are you aware of any situations where the existence of a control relationship among clients does not lead to a 'single risk'?*

The link between the concept of 'single risk' and the same probability of default should be clarified. The draft GL interpret 'single risk' cases as to the failure of a client that would lead to 'repayment difficulties' of another client of an institution. In this case, these clients shall form one group of connected clients.

Both under a control relationship and economic dependency, the chain of contagion leading to 'possible default' of all entities concerned is a relevant factor for the grouping.

We believe it should be clarified how such likeliness to default or to experience financial difficulties should be treated in the rating assessment of the members of the GCC, and especially in the cases when one member of the GCC defaults.



In our understanding (i) 'repayment difficulties' do not equate to 'default' and (ii) 'single risk' does NOT equate to 'the same probability of default'. However, this distinction is not clear, as the terminology of the draft GL uses wording that also apply for Article 178 CRR default definition that is a cornerstone of IRB rating systems.

We believe that the concept of existence of a control relationship leading to a 'single risk' can only make sense where control relationship does not mean the same probability of default. If that were not the case all counterparties within the same scope of consolidation of the parent undertaking would have to have the same PD/rating under the IRB Approach. This would not reflect the economic reality of the business entities.

This concept was also elaborated by external rating agencies and referred to as "Insulation" making it possible for a subsidiary to achieve a higher rating than that of a parent or a consolidated family if it is insulated.

As a result of insulation, parent companies may be prevented or restricted from accessing the resources of the subsidiary, through either regulatory or legal barriers, which prevent excessive dividend upstreaming, intercompany loans, or any "non-arm's-length" transactions. Insulation factors include: specific legal structures (e.g. SPVs and cash waterfalls), national legal systems (e.g. limits for dividends), explicit regulatory restrictions, separate management and/or board of directors, different countries with different legal jurisdictions, tax disincentives discouraging repatriation of dividends/cash.

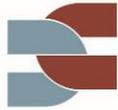
*Q.2 What is the likely impact of the clarification of having an exceptional case when the existence of a control relationship does not lead to a 'single risk'? Please provide an estimation of the associated quantitative costs.*

*Q.3 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.*

It is unclear why IFRS 11 (joint arrangements) and IFRS 12 (disclosure of interests in other entities) should be among the indicators of control without further explanation as to the rationale on which EBA considers them as relevant regarding the control criterion of Art. 4(1)(37) CRR. We do not see how these how these accounting provisions constitute control in terms of the CRR.

*Q.4 Are there any other indicators of control in the case of a similar relationship which are useful to add to this list of indicators?*

We see that there is no need for further indicators to be added. However, the list is not sufficiently clear in terms of relations among the situations described, i.e. ranking of criteria.



It should be clarified how the cases when more than one criteria is fulfilled by different natural or legal persons should be treated. This could be the case for instance where for the same legal entity one counterparty holds the majority of voting rights and a different counterparty holds the majority of shares of capital. We understand the majority of voting rights should be a decisive criterion for the control relationship.

*Q.5 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?*

We generally agree with the impact assessment and baseline scenario, the creation of a level playing field is essential for the purpose of these GL.

*Q.6 Is the guidance provided in section 5. 'Alternative approach for exposures to central governments' clear? If not, please provide concrete suggestions.*

*Q.7 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.*

As already highlighted, it is of the utmost importance to clarify the terminology used in the draft guidelines, especially in relation to the default definition. In our understanding 'repayment difficulties' do not equate 'default' and 'single risk' does not equate 'the same probability of default'.

An approach geared towards the vague term 'financial difficulties' would ultimately create new uncertainty when it comes to assessing the existence of a group of connected clients because there would then still be the question of how serious the financial difficulties due to economic dependencies would have to be to lead to the assumption of a group of connected clients. Without any further clarification of the term, we see an unintended threat of inconsistent client grouping practices in Europe. Temporary financial difficulties, such as the involuntary granting of a supplier credit or repayment difficulties resulting from the time needed to find a replacement for a customer that defaulted, by no means justify formation of a group of connected clients based on economic dependency and thus treatment as a single borrower, since there is no sustained single risk. The risk of default for the institution resulting from such client relationships would be clearly overstated. We understand that EBA also acknowledges this in para. 25 of Background and rationale subsection 3.2.3. Moreover, in para. 19 of the BCBS large exposures it is assumed that the crucial factor in formation of groups of connected clients is for two clients to be so dependent on each other that if one of them fails the other will very likely fail as well. We strongly believe there is no need for gold-plating at European level.



Therefore, we suggest to maintain the wording of the CEBS Guidelines ("substantial, existence-threatening repayment difficulties") as a sensible supervisory wording, the expression "repayment difficulties" alone is far too vague. The common understanding of the CRR wording has always been in the sense that the conditions to qualify as repayment difficulties need be substantial and permanent economic dependency.

*Q.8 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)?*

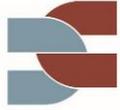
The list provided in paragraph 23 is detailed and seems quite exhaustive. However, in our opinion it will be very difficult to identify and prove these dependencies. In particular, it seems hardly feasible to assess the 'at least 50%' thresholds for instance with regard to customers operating in less transparent markets where such information is deemed to be confidential. Generally, in such cases it is possible to check whether the situations described in paragraph 23 materialise only if it is publicly available information. The cost of research and assessment on economic dependency relations would be disproportionate, and the threshold removed from the list.

*Q.9 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.*

We do not find the additional situation being considered by the EBA as appropriate for inclusion in the list, i.e. "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 case does not appear as an economic dependency situation, since the guarantee only refers to secondary credit risk. Differently from para. 23(a), the primary credit risk are unrelated to each other and cannot constitute a single risk due to risk diversification.

Additionally, we believe that these cases shall not be considered as connected. First, such a treatment would lead to a disadvantageous treatment in smaller Member States, where the availability of guarantors is limited and therefore a group of connected clients would be reached more easily than in larger countries. Further, it would be difficult for the institutions to obtain these information and to monitor these cases.

*Q.10 Is the guidance in section 7. 'Relation between interconnectedness through control and interconnectedness through economic dependency' clear? If not, please provide concrete suggestions. What is the likely impact of this guidance? Please provide an estimation of the associated quantitative costs.*



Interconnectedness through control differs fundamentally from interconnectedness through economic dependency. Any obligation to link these situations may lead to far reaching requirements for the identification of groups of connected clients. We oppose such an approach that would go beyond the requirements of Art. 4(1)(39)(b) CRR. The extent to which this would lead to restrictions to lending is something that cannot be fully assessed at the moment. This depends to a large extent on further decisions at European level on the implementation of the Basel Committee's large exposures framework, particularly whether the definition of 'eligible capital' is tightened further and how far existing exemptions and reduced requirements are addressed in future.

It should also be made clear how the two criteria (control and economic dependency) are to be separated and applied if both occur in parallel but in different directions. We could illustrate this with an example:

A holding company has a 100% shareholding in a subsidiary and the holding company is at the same time economically dependent on the subsidiary. The subsidiary, in turn, triggers a further economic dependency on a third party (legally independent entity). Which entity should be placed at the top of the group of connected clients? The subsidiary (which triggers the economic dependency) or the parent undertaking (as the controlling entity)?