8 September 2022

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EBF RESPONSE TO THE EBA CONSULTATION ON THE IDENTIFICATION OF GROUP OF CONNECTED CLIENTS

Question 1: Could you please indicate, if the approach of sections 4, 6 and 7 of the existing EBA guidelines, now transposed in the Articles of the draft RTS, remains sound and is implementable with no major challenge or unduly high costs. Please elaborate.

In general, guidelines leave too much discretion and too much room for interpretation to the authority, especially when considering economic dependency.

The burden of the proof is on the credit institution's side (not on the authority's side) that can cause demands/requirements which are hard to fulfill.

Moreover, we consider the implementation into the management and systems of section 7 of EBA Guidelines of Group of Connected Clients now transposed in Art 3 of the draft RTS is challenging as interconnectedness due to economic dependency has to be identified between subsidiaries considering:

- Economic dependency relationships, as opposed to information from control relationships, require quite granular information, which may not be obtainable. In the case of economic dependencies such as supply chain links or dependence on large customers, it is a commercially sensitive inside information. Generally, the information to identify economic interconnectedness has to be available in relevant entities. It is difficult to identify this type of interconnectedness for small subsidiaries due to the lack of information.
  Another issue is that in our experience in the application of the current guidelines, centralized databases are not available. Because of that, the procedures are very extensive and granular. It entails high costs and time regarding managing changeable information. Moreover, it is possible that different institutions will arrive at different results when analysing the same entities. The process is operationally complex and very burdensome, and manual routines are required with higher workload in the form of a more detailed analysis and more subjectivity.
- Assuming the information to identify economic dependency for relevant entities is available, the economic dependency will impact at Group level. Therefore, the identification of economic dependencies at Group level would simplify the process.
- In addition, when identifying an economic dependency at subsidiary level, we are of the view that the potential support of each Group to its subsidiaries in case of financial difficulties should be considered.

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The guideline isn't clear about whether or not pure natural persons without any commercial business that are interconnected to another natural person without any commercial business like husband and wife are in scope. Please see also our remarks on question 5.

Question 2. Have you identified any additional aspect(s) that would require clarification? In this vein, would you see the need for further illustrative examples (and if yes, on which precise situation or specific case)? Please elaborate.

Overall, we would prefer that the guidelines strike a good balance between rule-based guidance on economic dependencies and at the same time provide appropriate flexibility. The previous, and currently proposed, EBA approach based on a broader set of principles and examples, with a heavy emphasis on analysis and interpretation, requires a lot of manual work and may lead to differing outcomes in institutions, without a clear benefit.

More specifically, we consider the following cases to warrant further clarification:

- In the cases where the sum of all exposures to one individual client doesn't exceed 5% of Tier 1 capital, we consider that banks should just use readily available information with a proportionate approach, as it is stated in the current guidelines.

- There are aspects which might benefit from further guidance. Examples mentioned in the consultation document are comprehensive but universal. More detailed examples of group of connected clients in different industries would be beneficial. In terms of clarification, it is imperative for institutions to give due emphasis to the clause (cannot be replaced in a timely manner without excessively increased costs) – as, it could still be possible for the entity to easily (i.e., in a timely manner without excessively increased costs) find a replacement or to compensate for any losses (or foregone profits) inflicted by the party in financial difficulties without experiencing own repayment difficulties; in which case the institution does not need to consider these companies / persons as a single risk.

- In addition, it would be useful to have more information about the control and management procedures for identifying connected clients. For example, to what extent and at what point it is expected to collect data from large entities (several subsidiaries and sub-group parent companies). Bank's KYC-procedure is already extensive, and the backgrounds are examined in connection with granting of credit. Also, often banks´ own guidelines instruct to form a group of connected clients even before granting credit. However, EBA's guideline only talks about exposures (credit).

- Banks have many customers in different industries and of different sizes and partially therefore the group of connected clients has been perceived as complex. Sometimes it can be difficult to assess the significance of economic dependencies and/or control. From time to time some cases must be assessed case-by-case basis by interpreting the EBA guideline.

- Finally, we like to emphasize that when the RTS become effective, article 6 CRR make this RTS also compulsory for the large exposure regime at the individual bank basis. However, the Basel Large Exposure Framework is written from a consolidated view (see SCO10.1). However, Europe also applies the Large Exposure framework at the individual level. From the more than 70 paragraphs, the consultation paper only addresses in one paragraph (i.e. paragraph 22) that the draft RTS will also be applicable at intra group exposures of banking groups.

Therefore, it addresses the issues at a consolidated basis, but there is no extensive elaboration how the "consolidated" large exposure rules can also be applied on an individual basis toward subsidiaries and if this is the case, what issues emerge when looking at the group of connected clients. We are of the view that also in the cost benefit analysis EBA has not looked at this framework from the individual perspective. On page 35 of the consultation paper EBA writes that it only has performed the cost benefit analysis at the highest level of consolidation.
Although paragraph 5 of the draft ITS states that in exceptional cases no single risk prevails despite the paragraph 1, 2 or 4 of article 1, we considered it necessary that this is further explained and provided for with examples in the guideline and the wording in article 1 of the RTS.
For the individual Large Exposure analysis of EU banking groups, related policies and reports, adoption of this draft RTS without modification, would mean that almost the entire Banking Group (all direct and indirect subsidiaries of the ultimate mother that are in the IFRS consolidation), have to be considered as a single risk and therefore as one group of connected clients. Although the CRR leaves room for fully or partially exemption from the LE upper limit (25% of T1), we foresee increased:

- Compliance cost to identify all relevant exposures for the individual large exposure reporting
- Complications in the analysis on the possibility of exemptions and fulfilling the conditions for exemptions
- Risk of restrictions in intra group funding due to restriction set by the large exposure regime.

Without clear and sound guidance, the application of the large exposure rules at the individual basis could imply significant costs for large institutions in the Union with subsidiaries outside their own Member State.
In any case, we understand that the exemptions in articles 400 and 493 are not affected by paragraph 22, as is also suggested by footnote 6 of the consultation paper.

- Moreover, we believe that the relationship between General Partners / SGRs and Funds they manage as well as between Funds (including Private Equity Funds) and their related companies (SPVs / subsidiaries) deserve further explanation. Please see the annex for further elaboration.

Question 3. After considering the circumstances set out in Article 1 that constitute a single risk by means of control, could you please indicate if the described circumstances are sufficiently clear? Please elaborate.

In paragraph 3 – natural persons wouldn't have "management". We suggest clarifying the wording in this regard.

Question 4. Is the additional Scenario C 0 related to the determination of a group of connected clients by means of control, listed in Section 3.4.1 (Groups of connected clients based on a control relationship), sufficiently clear? Would you see need for further illustrative examples of a control relationship?

We would see need for additional examples considering there are structures different than SPVs, where the risk is segregated and there's no risk of contagious even though the control relationship exits.

Therefore, we would welcome the inclusion of those structures where risk is segregated (in addition to SPVs) and clarity in which cases it can be refuted to consider these exposures as single risks.

Question 5. After considering the circumstances set out in Article 2 that constitute a single risk by means of economic dependency, could you please indicate if the described circumstances are sufficiently clear? Please elaborate.

The wording would suggest that groups need to be formed also for households. This should be clarified going forward.

In addition, in paragraph 2 the ability to demonstrate no single risk may be challenging to implement in practice, especially if this would mean e.g. an audit trail for each decision. It should be possible for banks to implement these rules in their framework applying a rule based setup, built on the list in this Article and complemented with internal expertise on where applicable.

Article 2-1 j) should not apply to borrowers which benefit from a structuring enabling to isolate the borrower from the risk of bankruptcy of its shareholders, like in the case of specialized lending.

Question 6. In point (c) of Article 2(1), would you prefer following a quantitative approach by replacing the term "significant part" with a threshold of "50% or more" as envisaged in point 1 of LEX 10.16? What would be the advantages or disadvantages? Please elaborate.

We consider it is important to flag that the identification of economic dependencies is supported by a qualitative and quantitative approach. For this reason, we believe the replacement of the term "significant part" with a threshold of "50% or more" could weaken the comprehensive character of the analysis banks are pursuing on both ends as the focus will shift to the quantitative angle. As outlined in Article 2 of the RTS, economic dependency should be assessed according to various perspectives for determining the underlying dependency of a bank on an individual natural or legal person, such as (a) the risk of insolvency of the counterparty, the significance of the part of (b) guarantee, (c) funding, (d) supply or (e) receivables or liabilities of an entities, where (f) repayment risks may arise, (h) funding may not be replaced in a timely manner without excessively increased costs, (i) unified management basis and (j) administrative management decision may fall together with a major part of the same person.

Hence, even if a 50% threshold would allow for more homogeneity of the identification criteria for economic dependents across the banking industry. We are of the view that, in addition to any quantitative analysis/threshold, a qualitative analysis should be carried out in the identification of economic dependency relationships.

As the industry concluded also in the GL consultation in 2017, a quantitative threshold restricts the tailored approach needed for adequately capturing the different qualitative angles and the different business models of a bank's clients.

It is important to make a comprehensive case-by-case analysis, including the assessment of potential losses and their significance as well as how easy it is to replace the funding, in case of funding problems (if the economic dependency is based on funding source, the criteria of identification of economic dependents based on concentration of revenues or expenditures in one group will not be applied).

Question 7. What is your view on the wording "that cannot be replaced in a timely manner without excessively increased costs" compared to the wording used in the GL "that cannot be easily replaced"? What do you think about this change, is it more comprehensible? Please elaborate.

Even significant costs do not matter if they can be repaid. We suggest a reference to "significant financial difficulties" rather than increased costs, because there could be a scenario where even significant / excessively increased costs could be repaid.

Question 8. Is the additional Scenario E 8 related to the determination of a group of connected clients by means of economic dependencies, listed in Section 3.4.2 (Establishing interconnectedness based on economic dependency), sufficiently clear? Would you see need for further illustrative examples of an economic dependency relationship? Please elaborate.

As was also mentioned by attendees during the public hearing, we would welcome more clarity on how resulted single risk has to be reported under scenario E8 - case of horizontal group by means of economic dependencies. It is not clear in which group should be allocated the single risk as there is no control between A, B or C.

Question 9. After considering the circumstances set out in Article 3 that constitute a single risk by means of the combined existence of control and economic dependencies, could you please indicate if the described circumstances are sufficiently clear? Please elaborate.

See comments in Q1.

Question 10. Is the additional Scenario E 7 related to the determination of a group of connected clients by means of the combined existence of control and economic dependencies, listed in Section 3.4.3 (Relation between interconnectedness through control and interconnectedness through economic dependency), sufficiently clear? Please elaborate.

No comments.

ANNEX: Additional elaboration to the response to question 2

- SECTION 1 provides some specific cases regarding the relationship between General Partners / SGRs and Funds they manage as well as between Funds (including Private Equity Funds) and their related companies (SPVs / subsidiaries) – supported by graphical examples – aimed at representing situations deserving further investigation,
- SECTION 2 provides a proposal with some criteria that the bank would consider can be used to demonstrate the absence of a unique risk between the aforementioned Funds and their related companies (referred to below as "portfolio companies").

SECTION 1

Example 1

Fund 1, managed by GP A, is investing - through an SPV (SPV A) – with 100% interest (or, generally speaking holding the majority of the shareholders' or members' voting rights) in Company A. Fund 1 through a different SPV (SPV B) invests in Company B, again with 100% participation (or, generally speaking, holding the majority of the shareholders' or members' voting rights). The two companies are separate, independent and have no connection between themselves. Each "shareholding" of the Fund passes through SPVs that are isolated from each other and from the Fund hence a company liquidation does not automatically trigger a liquidation of the Fund or an event of default, rather it would represent a reduced return for the Fund, which would not create financial difficulties. In addition, the Fund liquidation event would not automatically lead directly to an insolvency procedure for any of the company owned by it as the investments are bankruptcy remote (no downstream / upstream dependence). Please see below a graphic presentation for this example 1 with clear indication of a bank's clients/counterparties: per example below the bank's clients would be Company A and SPV A, Company B and SPV B. Each is funded through bankruptcy remote structures isolated from each other.

Based on the guidelines, section "Establishing interconnectedness based on economic dependency" in the light of the situation above the downstream or upstream contagion would be limited between Company A and SPV A on one side and, separately Company B and SPV B. Since the bank's clients would be Company A and SPV A, Company B and SPV B and each shareholding of the Fund passes through SPVs that are bankruptcy remote structures isolated from each other, our approach would be to form a group at each SPV level (Group 1 including only SPV A and Company A, Group 2 including only SPV B and Company B; no group with Fund and / or GP A[1] see Figure 1): Can you please confirm correctness of our approach?

Can you please confirm that a similar approach is feasible also if there is no SPV and therefore Fund 1 is directly connected with Company A and Company B; in fact we consider that also in such case company A or B liquidation would all be treated as stand alone in a credit risk perspective.

Can you confirm such approach (please see figure 1a)?

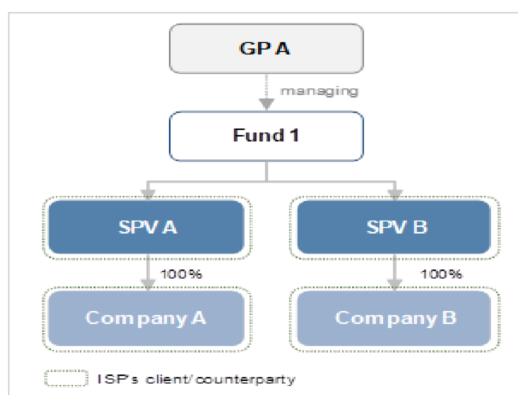

Figure 1

[1] Cases where the applicable local regulatory framework for the specific entities in question (i.e. link between GPs and their managed funds) already provides for segregation are outside the scope of this paper.

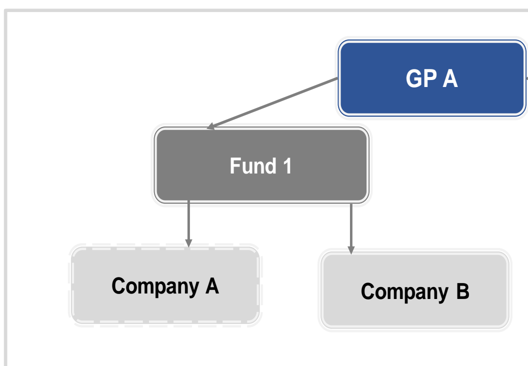

Figure 1a

Example 2

Fund 1, managed by GP A, is investing through SPV X with 100% interest (or, generally speaking, holding the majority of the shareholders' or members' voting rights) in Company A. Fund 2, managed by the same GP A invests through a different SPV Y in Company B, again with 100% participation (or, generally speaking, holding the majority of the shareholders' or members' voting rights).

The two Companies A and B are separate, independent and have no connection between themselves. Please see below a graphic representation for this example 2 with clear indication of the bank's clients/counterparties:

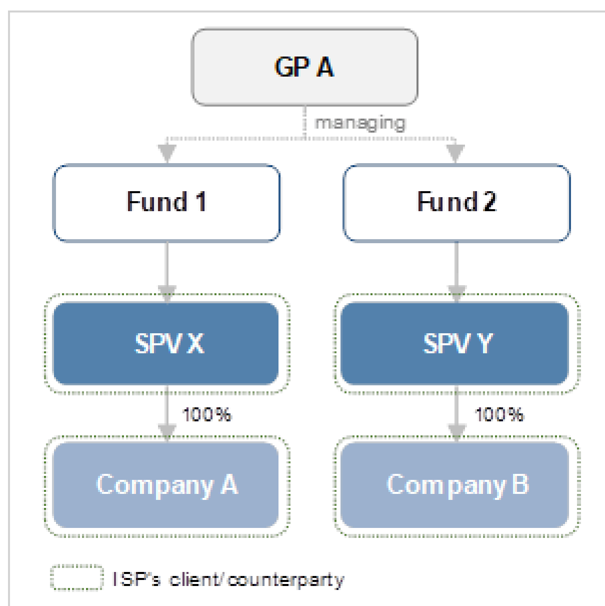

Figure 2

Orientation

In this case, while SPV X and Company A should be connected (as well as SPV Y and Company B, but in a separate group) with each shareholding of the Fund passing through SPVs that are isolated from each other (bankruptcy remote structures). In our opinion it would appear we can exclude GP A, Fund 1 and Fund

2 from the definition of connected customers, since there is no risk of contagion among them [in line to what stated in the Example 1 [and example 1a]

Based on the guidelines, section "Establishing interconnectedness based on economic dependency" it appears that only SPV X and Company A should form a group, as well as Company B and SPV Y. Furthermore, the fund has developed bankruptcy remote structure to fund each investment hence no recourse to the fund would be available in addition to the equity already invested. In addiction neither the Fund can utilize the return it has obtained from Company B to eventually sustain Company A as it would have to return everything received to its relative LP's (Lp of each fund do not coincide hence cannot be freely exchanged).

Again there is no chain of dependency above SPV X and SPV Y, in line with the aim of establishing bankruptcy remote structure for each investment.

In this case our orientation would be to form Group of connected clients at SPV level (e.g (Group 1 including only SPV X and Company A and Group 2 including only SPV Y and company B).

Can you please confirm the correctness of our approach?

Example 3

Fund 1, managed by GP A, is investing through an SPV with 100% interest (or, generally speaking, holding the majority of the shareholders' or members' voting rights) in Company A. Subsequently, Company A buys a majority interest in the capital of another company, Company B. The two companies become part of a single group.

The two companies become part of a group. Please see below a graphic presentation for this example 3 with clear indication of the bank's clients/counterparties:

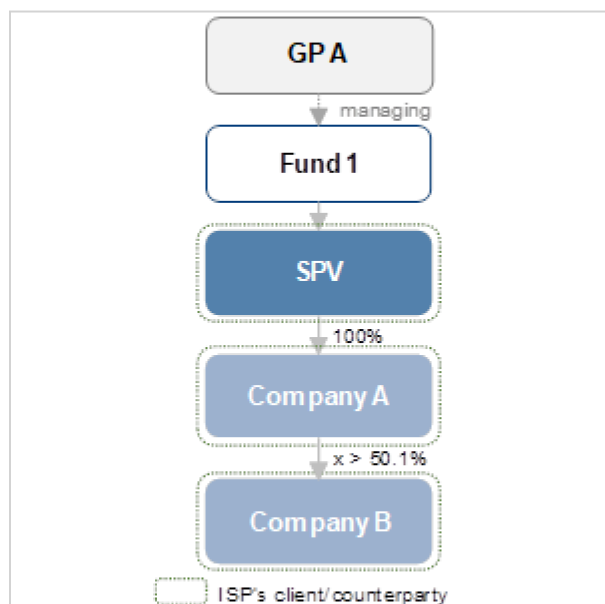

Figure 3

In this case the SPV, Company A and Company B are connected clients and create a group. They will publish consolidated financial statements and will fall within the definition of single risk as there is a strong assumption that a contagion risk is existing because of the economic and controlling relationship among them.

GP A and Fund 1 made their shareholding of the Fund passing through bankruptcy remote structures SPV is isolated from the fund. There is no down or upstream dependency given the bankruptcy remote structures in place.

Based on the guidelines, section "Establishing interconnectedness based on economic dependency" the group of connected customers should be set at the SPV level as the risk of contagion and financial dependency stops there. As a matter of fact upstream and downstream is limited to Company A, Company B and the SPV but it does not extend to Fund 1 and GP A for the same reasons we said before under example 1 and 2. Therefore the Group would only include only SPV, Company A and Company B.

Can you please confirm the correctness of our approach?

SECTION 2

Below are proposed some criteria that could be considered as usable to demonstrate the absence of a single risk between the aforementioned Funds and their associated companies (referred to below as "portfolio companies").

This, consistent with document EBA/GL/2017/15 - Final Report - Guidelines on Connected Clients under Article 4 (1) (39) of Regulation (EU) No. 575/2013 - in which it was pointed out that:

- although institutions should first assume that customers with a controlling relationship with each other constitute a unique risk, it is possible for institutions to disprove this assumption by showing that there is no unique risk despite the controlling relationship. In this vein, the Final Report helpfully points out that the assessment of a control relationship "is only the first step in the assessment of the connections among clients, before assessing any potential economic dependency" (see 2.2.1(11) of the Final Report – p. 8).
- "institutions are responsible for demonstrating to competent authorities, and documenting appropriately, that in a specific case a control relationship among clients does not lead to the existence of a single risk and, therefore, to a grouping requirement on the basis of control" (see p. 51)

Proposed criteria for assessing the absence of single risk

Case 1 - assessment of the possible contagion of the portfolio company by the Fund suffering financial stress.

a) Since the Fund's initial investment in the portfolio company, there have been no frequent capital increases.
If this requirement is verified, this means, in our view, that the Fund is operating correctly and in accordance with its mandate, i.e. avoiding injecting additional liquidity in the face of possible difficulties of the portfolio company, which is normally assessed individually for its ability to generate income, without recourse to guarantees or new financing from controlling shareholders.

b) Any balance sheet liabilities of portfolio companies are represented, for example, by bond issues or loans received involving third parties other than the Fund
If this requirement is verified, this means, in our view, that the obligations of the portfolio company are unrelated to those of the controlling entity (Fund), which, by its nature, is typically required to invest a maximum share of its assets in each individual target and therefore does not normally exceed these concentration limits, by providing additional liquidity to the portfolio companies in addition to the initial allocation.

c) The Fund does not own - through a chain of ownership separate from that of the "portfolio company" concerned - other subsidiaries with which the "portfolio company" itself has business synergies (e.g. within the same industrial sector), with the result that the Fund together with all its subsidiaries is not to be regarded as a single industrial group.
If this requirement is verified, this means, in our opinion, that the Fund is operating according to a correct logic that identifies it as a pure investment vehicle that aims at an adequate diversification (sectoral and/or geographical) in the interest of its participants and whose other investments do not present the same degree of correlation with each other, as is the case in an industrial group. In an industrial group, in fact, the subsidiaries generally all operate in the same sector of activity or cooperate, each in its own role, in the production of goods and services that represent the group's core business, so that if one of them encounters financial difficulties, the others will most likely suffer as well (domino effect).

Case 2 - assessment of the possible contagion of the Fund by the portfolio company (controlled entity) suffering financial stress

a) The Fund has a relatively large and diversified portfolio in which the relative weight of each portfolio company (concentration limit) does not exceed a certain threshold, e.g. 20%.
If this requirement is verified, this means, in our opinion, that the impact on the Fund of any financial difficulties affecting one of the portfolio companies should be limited and not jeopardize its proper functioning, since the Fund could continue to benefit from the capital and financial strength of the other portfolio companies in the portfolio.

b) The Fund's target IRR is sufficiently high to ensure adequate levels of liquidity for the Fund.
If this requirement is verified, this means, in our opinion, that the risk of affecting the solvency of the Fund due to a poor performance of any one - taken individually - of its investments is reduced; this, as the revenues generated by the other portfolio companies would be more likely to compensate for the investment with a negative performance.

c) There is de-correlation of the portfolio company's business risk from the Fund's inherent business risk, in the sense that the Fund acts, according to proper logic, as a pure investment vehicle implementing adequate diversification (sectoral and/or geographical) of its investments in the interest of the shareholders

If this requirement is verified, this means, in our opinion, that there is no risk of having a high degree of correlation between the various investments, as is usually the case in an industrial group that would have an interest in exploiting synergies with its subsidiaries; therefore, in the absence of correlation, the possible difficulties of a portfolio company would not affect the solidity of the Fund.

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