BPER Gruppo responses to the EBA Consultation Paper

"Draft Regulatory Technical Standards on the identification of a group of connected clients under Article 4 paragraph 1 number 39 of Regulation (EU) No 575/2013"

September 2022

We would like to thank the European Banking Authority for the opportunity we were offered to comment on this consultative document. For the purpose of improving clarity and consistency with the comprehensive large regime framework and the lending processes as regulated by the "EBA Guidelines on loan origination and monitoring", we suggest introducing few amendments in the RTS, as reported below.

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.

Answer 1.

In our opinion, the approach of sections 4, 6 and 7 of the existing EBA guidelines, as transposed in the Articles of the draft RTS, is sound and clear. The new examples added to the version of the existing GL complement the framework, and provide an answer to the required clarifications.

We believe anyway that, with reference to less significant exposures, the requirements of the provisions are perhaps too burdensome to be fully implemented without major challenges and high costs.

For the sake of clarity, it could be worth drawing attention to the fact that SMEs and microenterprises are more frequent than any other type of organisation when European banks are called to identify groups of connected clients.

SMEs account for 99% of all businesses in the EU; in Italy, a recent analysis based on Italian companies' registers showed that there are over 160 thousand limited companies and over 4 million microenterprises complying with the European definitions. According to the Italian National Institute of Statistics (ISTAT)'s latest *Rapporto Imprese 2021* "in 2018, 75.2% of Italian enterprises having at least 3 employees were controlled, directly or indirectly, by a natural person or a family". This share almost reaches 80% in micro enterprises but decreases to 51% in medium enterprises, and 37% in larger enterprises.

Consequently, the identification and update of GCC related to an SME or a microenterprise owned by a natural person(s) or a family under the terms defined in the new E7 scenario could be more time-consuming than for larger groups and it could involve a significant workload for Credit Institutions, with major impact also on the origination and monitoring processes. For further details on scenario E7, please refer to answer 10.

At the same time, as was pointed out during the CA interview, while the evidence of a "control" relationship -as stated in current GL, article 13 a) and b) - is easily gathered from publicly available datasets and internal systems by the bank which consequently can identify a control chain, the “significant influence” relationship is more difficult to detect and assess, given the margin of discretion that is inherent in the evaluation.

Furthermore, in our opinion, all discretionary assessments entail a very hard effort of further investigation and the following key risks:

- risk of over-caution: heightened conservatism could lead to identify groups of connected clients extending beyond the actual perimeter of single risk, penalising a bank which adopts a more prudent approach (for example this could result in a penalisation when applying the SME supporting factor);
- risk of underestimation: on the contrary, a less cautious approach could lead to underestimate the risk of contagion of economic difficulty, in turn causing delayed intervention in credit assessment/classification and belated adoption of the necessary remedial actions;
- risk of undue cost and effort: even though the RTS clearly specify that the investigation of economic dependencies among clients should be proportionate to the size of the exposures, and that extensive “soft information” research should be conducted in all cases where the sum of all exposures to one individual client exceeds 5% of Tier 1 capital, the internal processes and external regulations require that control and economic dependencies be assessed without a defined threshold;
- risk of ineffectiveness: the number of groups of connected clients detected in the internal systems, including as a result of their integration with external database information, is such that it would require the definition of additional thresholds in order to specify which exposures need further assessment to identify any potential contagion due to economic dependency and the new E7 scenario.

Besides the investigation aimed at identifying the more qualitative or “soft” indicators of control, when implementing the EBA Guidelines on Connected Clients, we noticed that major issues had emerged from the detection of economic dependency, mainly due to the continuous evolution of economic relationships among clients, especially in the changing times we have been experiencing since 2020, and to the lack of information about economic dependency with traditional instruments.

Finally, the difficulty or longer time required to correctly identify groups of connected clients could result in negative impacts on core origination and monitoring processes (e.g. the decision-making structure in origination and monitoring processes).

In conclusion, based on these considerations, we propose that a threshold for exposures be set to investigate significant influence and economic dependencies: based on our evidence, we believe 0.25% of the institution’s Tier 1 capital would be adequate to assure a trade-off between the identification of any potential chain of contagion and an acceptable effort in lending processes. The proposed 0.25% threshold would also be consistent with the threshold adopted in Commission Delegated Regulation (EU) No. 1187/2014 of 2 October 2014 for the “unknown client” in the Large Exposures regime. On average, the exposure above the proposed threshold in our institution accounts for less than 1% of the Group of connected clients in number but almost 70% in terms of total lending amount.

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

Answer 2.

No, we deem the Draft RTS is complete and clear.

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.

Answer 3.

In our opinion, as elaborated in our Answer to Question 1, it would be preferable to specify that Article 1(1), and Article 1(2) point a) and b) – i.e. control relationship identifiable and detectable by means of relevant information (shareholders and % share of voting rights) - have to be applied to all exposures.

At the same time, including with a view to avoiding differences among member states - we propose that a threshold be specified, above which further investigation should be conducted with regard to dominant influence and other circumstances. The threshold should be expressed as a percentage share of Tier 1 Capital, and in our opinion it should be adopted also for the application of Article 2 (economic dependencies) of the proposed RTS.

Finally, we observe that Article 1(5) specifies that "where an institution is able to demonstrate that no single risk prevails despite the circumstances of paragraphs 1, 2 or 4 of this Article being met with regard to two or more natural or legal persons, these persons need not be treated as a group of connected clients". We believe that where the circumstances of paragraph 3 (the only one missing in Article 1(5)) are met, but adequate ring-fencing exists, the persons need not be treated as a GCC.

We suggest that paragraph 3 should be included among the circumstances, amending Article 1(5) as follows:

"In exceptional cases, where an institution is able to demonstrate that no single risk prevails despite the circumstances of paragraphs 1, 2, **3** or 4 of this Article being met with regard to two or more natural or legal persons, these persons need not be treated as a group of connected clients."

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?

Answer 4.

We deem the additional Scenario C 0 is clear.

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.

Answer 5.

Yes, we believe the described circumstances are clear and complete.

We believe that a common threshold to investigate economic dependencies would be strongly appreciated, also with reference to new Scenario E 7.

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.

Answer 6.

We believe that the interpretation of “significant part” depends on the specific situation.

In our experience, even though in a first phase of the EBA/GL implementation our Bank introduced a quantitative threshold for revenues (>50%) and guarantees as an assumption for the economic dependency assessment, we deemed the approach to be incorrect and decided to investigate the economic dependencies regardless of the amount of revenues/turnover. The considerations that emerged during the application of the EBA Guidelines, led us to focus more on the analysis of the impact on the counterparty’s cash flows and to investigate the potential spread of the financial difficulty resulting from the interruption of cash flows between the parties. This may also occur, for example, with less significant amounts of turnover but it would still determine a significant share of the entity's cash margins. To this end, we believe that a quantitative approach could lead to incorrect or incomplete conclusions.

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.

Answer 7.

We would prefer the proposed rewording, because in our opinion the economic effect of replaceability should be assessed in terms of its impact on the counterparty’s cash flows, as the mere 'irreplaceability' or 'difficult replaceability' between the parties could lead to incorrect assessments, while the “time and cost” principle is in our opinion correct.

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.

Answer 8.

Yes, we believe the additional Scenario E 8 and Section 3.4.2 are clear and complete.

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.

Answer 9.

The circumstances described in Article 3 are clear and complete.

Additionally, we think that the explanation of control and economic dependencies provided in previous Sections 4 and 6 of EBA/GL/2017/15 (as transposed in Paragraph 3.4.3 of the Consultation Paper) are sufficiently clear and we appreciate the coverage given to different kinds of economic dependency, including clarification provided on the variations on the baseline scenario, the chain of dependency and the upstream and downstream contagion effect.

However, it is worth observing that, in practice, the limits arising from the identification of a chain of contagion are still the main obstacle in identifying economic dependency for clients that have different control relationships, mainly for the reasons already pointed out in Scenario Mm 1 of EBA/GL/2017/15.

We estimate that in the upcoming years, using new technologies and new sets of information (PSD2 data, big data…), banks will be able to manage information regarding the entire supply chain links among their customers, and this will enable them to better evaluate the risks and opportunities arising from their commercial and economic relationships.

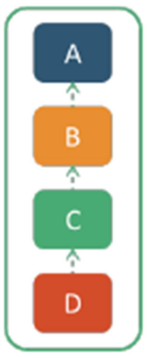
Where these economic interconnections are such as to identify economic dependencies, it would be advisable to clarify whether the “group of connected clients” should have the same relevance in the processes of credit origination and monitoring on the one hand and in the application of the regulations on capital requirements and the large exposure regime, on the other.

In our view, it would be worth exploring whether the standards under review should place different emphasis on legal interconnections and economic interconnections, and whether this should lead to different applications between mere 'groups of connected customers' established on the basis of legal interconnections and 'groups of connected customers' established on the basis of economic interconnections, or on legal and economic interconnections.

The following example is preliminary to further considerations.

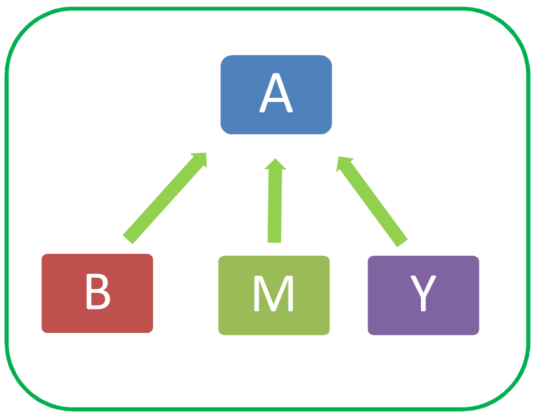
Example: *SMEs providers of a Large Listed company – Supply chains*

C is a SME and works mainly for A, a Large and listed company.



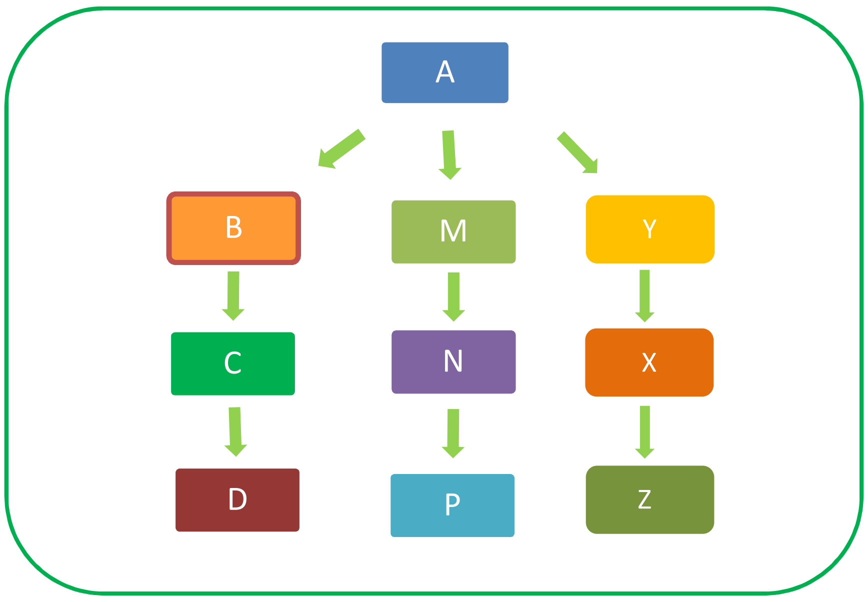
The Bank identifies the economic dependency between C and A, and all the chains of dependency, as stated in Scenario E/4 of the RTS.

At the same time, being A a Large and listed company, many other SMEs presenting economic dependency from A are identified and connected.



Under scenarios E/1 and E/2 “it is irrelevant that there is no dependency among” the individual entities having economic dependency from A, and “they have to be included in the same group of connected clients”.

Consequently, a very large number of companies have to be included in the same group of connected clients: B and its supply chain (C; D), M and its supply chain (N;P), Y (X;Z) and its supply chain, and so on, with different supply chains getting involved.



Assuming that all the entities included in the supply chains originated by B, M, Y are retail SMEs, we ask for you confirmation that it would be correct to apply the SME Supporting Factor to such entities in these cases, and conversely, that it is not correct to classify them as 'Corporate' exposures only because they belong to A's 'Group of Connected Clients' .

With specific reference to capital requirements and regulations, we think that economic interconnections should be excluded for the purposes of: classification of clients in the retail exposure class under Articles 123(c) and 147(5)(a)(ii), development and application of internal rating systems (Article 172(1)(d)), the requirements for net stable funding for reporting purposes (Article 428(1)(g)(ii)) and application of the SME supporting factor (Article 501(1)) .

It should also be explicitly accepted that all credit processes are implemented in such a way as to ensure that the assessment of the group of connected clients in the origination and monitoring phase is proportionate and adequate to the type of counterparty and exposure under evaluation.

The EBA Guidelines on Loan Origination and Monitoring (EBA/GL/2020/06) establish, among other provisions, that "if the borrower is a member of a group of connected clients, institutions should collect the necessary information on relevant connected clients, in accordance with the EBA Guidelines on connected clients."[1]

In our opinion, it would not be efficient to evaluate A (and its group of connected clients, based on its consolidated financial statements) every time we assess one of the SMEs involved in the supply chains, both in origination and monitoring; in such situations, it would rather be more efficient to evaluate –at a subportfolio level- the entities that are economically dependent on A (in the example above, all the supply chains) in order to avoid unintended sectoral concentrations and timely detect and address any economic difficulty that may propagate from A.

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

Answer 10.

[1] Art. 93, EBA/GL/2020/06

We welcome the clarification provided regarding "common ownership" and the creation of a group of connected clients through control and economic dependency.

It is necessary, however, to point out that the approach introduced under scenario E7, could entail undue costs and major effort in the GCC identification process.

The new scenario clarifies that, in case of common ownership, where no one holds the majority of shares or voting rights (and hence the definition of "control" is not met), the institution:

1. should first assess if anyone of the minority shareholders with a significant stake can exercise a significant influence[2],
2. Secondly, the institution needs to assess any economic dependencies between the persons concerned. If it cannot be ruled out that there is an economic dependency between the other shareholders and the one/s who could exercise a significant influence, a single comprehensive group including the entities and the shareholders needs to be formed (with no separate control or economic dependency groups).
3. In contrast, if it can be demonstrated that the shareholders are adequately ring-fenced and/or independent, after forming the control group with the relevant shareholder"P1", the reporting institution still needs to assess whether other economic dependencies could prevail, e.g. whether financial difficulties of the other shareholders could spread to the entities. If this is the case, another economic dependency group comprising the shareholder that could trigger funding or repayment difficulties and the entities concerned needs to be formed, in addition to the control group of P1. It is noted that other economic dependencies (e.g. relevant revenues) would require other groups to be formed.

As already pointed out with reference to economic dependencies and control to be assessed by means of "soft information", we would strongly recommend the adoption of a pragmatic solution for less significant exposures.

In our view, possible solutions are:

- the exclusion of less significant exposures from the provisions at issue (by means of the adoption of a threshold for expert assessment, e.g. 0.25% of Tier 1);
- as an alternative, we deem it may be viable to consider all the relevant persons of the family or group of persons who jointly hold control over an entity classified as an SME or Microenterprise (and not held via controlling links by a non-SME) as part of the same group of connected clients and included in the single risk perimeter, except when the bank considers that the revenues / wealth of such natural persons are not primarily related to / arising from the SME.

This latter solution, although possibly excessively cautious and conservative, would strongly reduce the effort that would be required in applying the provisions of Scenario E7 to SMEs and micro-enterprises, given their large number.

[2] See footnote 9 page 20 "Where a shareholder owns less than 50% but still holds a significant stake and has the ability to exercise a dominant influence, institutions need to assess the grouping requirements on the basis of a case-by-case analysis."