Consultation response

EBA Consultation on Guidelines on Connected Clients under Article 4 (1) (39) of Regulation (EU) No 575/2013

24 October 2016

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Banking Authority's (EBA's) consultation on Guidelines on Connected Clients under Article 4 (1) (39) of Regulation (EU) No 575/2013. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Overview/Executive Summary

AFME and its members support the overall aim of ensuring consistency and avoiding overlaps with regulations and guidelines that have been published subsequent to the original 2009 CEBS Guidelines in relation to the issue of connected clients. However, we believe that a number of the proposals within the consultation go beyond creating consistency and avoiding overlaps to introducing additional expectations which require further clarification and in some instances go beyond the stated intent of capturing 'single risk'.

Regarding the assessment of economic dependency, we have noted that the requirement to form a group of connected clients has changed to instances when failure of a client would lead to 'repayment difficulties' from the 2009 CEBS Guideline expectation of 'substantial, existence-threatening repayment difficulties'. It would be helpful to provide a more precise definition of 'repayment difficulties' and to closely link its definition to the event of default; we believe this should mean repayment difficulties where the default of the counterparty is highly probable. This definition will ensure that connections captured are meaningful for the purposes of capturing 'single risk' and the framework remains aligned with the rationale of the Basel Committee, which specifically designed the large exposures framework to protect banks from large losses resulting from the sudden <u>default</u> of a single counterparty.

In the process of identifying economic dependencies and as recognised in the Guidelines, it will rarely be possible to implement automated procedures. The process for identifying connected clients is operationally complex, in particular where connections are vis-à-vis parties that are not an institution's clients (indirect counterparties). In addition to the practical difficulties in identifying such dependencies, this will have material cost implications for institutions and we ask that the requirement to identify economic dependencies not be extended to beyond an institution's client base. The cost implication is amplified in relation to investigating potential economic dependencies of entities / parties that are not part of an institution's existing client base as attaining the information will be more difficult and the costs associated with building IT systems and storage capacity for this information will be significant.

The cost would be particularly high for investigating and maintaining information regarding non clients. There is also a significant risk of imperfect linkages where non clients are concerned, as firms do not have access to an active dialogue with the party concerned to confirm the suspected relationships. It must also be recognised that sourcing this information will have impacts on customers, who will be required to furnish firms with considerably more information regarding their customers and suppliers to allow robust identification and are in our view not commensurate with the purpose of the large exposure regime; the large exposures regime is to 'set prudent limits to a single borrower or a closely related group of borrowers'[1] and thus limits its focus to counterparties (clients) and groups of connected counterparties of the institution and not beyond. If this requirement remains however, we believe the statement 'Institutions shall take reasonable steps[2] to acquire this information.' as well as 'that it must be in a position to demonstrate…its process is commensurate to its business' are key as it will allow firms to develop proportionate approaches for investigating connections via indirect counterparts.

Additionally, we believe the Guidelines would benefit from clarity in the area of situations for identifying economic dependencies. In particular, we believe it should be made clear that the situations are not intended as requirements i.e. there is no requirement to investigate each situation, but the situations are intended as useful items for consideration and reasonable efforts should be made to consider the situations where considered relevant and where the information necessary to make a robust determination is available to the firm.

Finally, we note that the 2% of eligible capital threshold for intensive investigation of potential economic connections remains inconsistent with the 5% of Tier 1 capital threshold recommended by Basel. The asymmetric compliance burden versus those that have adopted the 5% threshold, which will increase with the proposed change in threshold from 2% of own funds to 2% of eligible capital, creates a competitive imbalance and harms the level playing field between European banks and banks from other jurisdictions. In addition, the 2% trigger seems to be unnecessarily restrictive, potentially leading to the establishment of non-significant groups of connected clients and increasing banks' efforts without meaningful prudential benefits. Therefore, this threshold should be reconsidered as part of these revisions.

[1] http://www.bis.org/publ/bcbs283.pdf - Paragraph 2

[2] 'Reasonable steps' is understood to mean firms will use all existing information held by the institution and gained through regular customer file reviews per the firm's existing review cycle to identify economic dependencies, as well as investigate for additional economic dependencies where there is new information to suggest the existence of previously unidentified economic dependencies.

Questions

Group of Connected Clients based on control

Question 01: Are you aware of any situations where the existence of a control relationship among clients does not lead to a 'single risk'?

There are instances where the existence of a control relationship among clients does not lead to a 'single risk', mostly relating directly or indirectly to the public sector and to Private Equity and Real Estate Funds. We believe these should be exempted from the requirement to record these connections for the purposes of identifying connected clients and have outlined our reasoning below.

Paragraph 37, 2009 CEBS Guidelines on the implementation of the revised large exposures regime states, in relation to clients that are connected by the central government, that there is no requirement to group these clients because "even though the owner has control over each entity, the risk connected with the exposure to one entity is normally not related to the risk of the exposures to other entities. In addition, the failure of one entity, which is a separate legal person, does not necessarily impose a duty on the owner to invest more capital" (Paragraph 37, 2009 CEBs). This logic applies to companies owned by the same private equity funds if some conditions are met. These conditions are the following:

- Non-recourse financing
- Secured financing structure to avoid any negative support and allow the bank to take the control of the entity in case of problem.

In our view, the treatment of companies owned by private equity funds justifies the application of the exemption from the requirement to group clients in relation to "control".

This logic can apply more generally to situations where the ownership relationship between a company and companies in which it holds participations, even controlling participations, does not necessarily create a default correlation and is therefore not a reason to create a connection. Investment holdings would fall in this category. Fund managers, for instance, may have investment holdings across a number of portfolios which in aggregate constitutes a majority holding. However, control of the fund manager is not unfettered (and not control in the CRR sense) as it must meet the fund objectives and is monitored by the Custodian[3]. Note, FASB and IASB do not require consolidation of 'controlled' entities in which a private equity (PE) firm has investment holdings as it recognises the limits to how control is exercised and the PE model being based on investment income and capital appreciation, rather than access to the investees' assets or liabilities.

Similarly, in project finance transactions structured with limited recourse and a full security package, the project company does not have to be connected to its shareholder or shareholders because the purpose of the financing structure is to finance the project on its own merits without recourse to its shareholders. Finally, in some asset finance transactions, the connection with third parties such as charterers for shipping transactions or lessees for real estate and aircraft transactions may be more relevant than the connection with the shareholders of the company owning the asset.

Note that in these various cases, consistent with this logic, the default probability assigned to these entities (LBO companies, project finance companies, asset finance funding vehicles) does not incorporate any support from shareholders. Risk parameters therefore reflect the absence of default correlation and connection between these entities and their shareholders.

In this respect, it is worth noting that IFRS 10 requires the consolidation of certain SPVs and therefore the risk of repayment difficulties has already been internalized by the consolidating institution in these

[3] See Annex for scenarios highlighting how instances of fund management control should be interpreted.

instances. As such, it would be inappropriate to capture these as connected clients for the purpose of capturing 'single risk' as the risk has already been captured. Additionally, where the SPV is established for securitization purposes, if there was a risk relationship it would only be with the debtors of the underlying assets, without the need to map the connection with the vehicle.

Under the current RTS on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets, banks have already taken all the reasonable steps to look-through to the underlying assets and to identify the obligors of all credit risk exposures underlying the transaction. Even where the underlying obligors cannot be identified, the exposures are to be aggregated into a single hypothetical 'unknown client' and the large exposures limit applied to the 'unknown client' in the same way it applies to any other single client. Thus, the 'control relationship' criterion appears irrelevant in view of this type of risk positions (transactions with underlying assets).

In practice, another very important defining feature common to many SPE is the bankruptcy remoteness. By construction, such ring-fenced characteristics mean an SPE's assets are isolated from any originators or creditors of its sponsoring firm should the latter go into bankruptcy, even though the accounting rules could require the relationship to be deemed 'controlling'.

Question 02: 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.

The likely impact will depend on the level of documentation required. Paragraph 12 of the Draft Guidelines states that institutions recognising an exceptional case 'should document the relevant circumstances which justify this case in a detailed and comprehensible manner'.

AFME suggests that EBA should specifically state that 'detailed' should be interpreted as being proportional to the risk posed. An absolute statement on what is meant by 'detailed' could have significant cost implications.

Question 03: 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.

No, we believe this to be clear.

Question 04: Are there any other indicators of control in the case of a similar relationship which are useful to add to this list of indicators?

No, we view the existing indicators as very prescriptive and do not believe the inclusion of additional indicators is warranted or necessary. We would, in fact, favour an approach for identifying client interconnectedness which is based on auditable principles or policies for monitoring control relationships and similarly for economic dependencies.

Question 05: 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?

Firstly, we appreciate your consideration of feedback from institutions in this area and welcome the recognition of consolidated accounts as a source to establish control relationships.

In respect of instances of control relationships excluded from consolidated reporting requirements by way of exemption, the expectation that these control relationships are captured should be limited to instances where the financial statements or other official documentation (e.g. public registries) make mention of such relationships. In addition, it should be explicitly recognised in the guidance that reasonable efforts should be made in capturing these relationships and that further investigation to identify relationships is not expected other than brought to light through the normal course of business.

Question 06: Is the guidance provided in section 5. 'Alternative approach for exposures to central governments' clear? If not, please provide concrete suggestions.

The statement in the 2009 CEBs guidelines on exposures to central governments (paragraph 37) is still deemed relevant. In particular:

'the risk connected with the exposure to one entity is normally not related to the risk of the exposures to other entities. In addition, the failure of one entity, which is a separate legal person, does not necessarily impose a duty on the owner to invest more capital. If the owner still decides to do so, it is assumed that this ultimately could be financed by raising revenues.'

As such, the existing treatment of central governments per Article 4(1)(39) of the CRR should continue. The inclusion of exposures to Central Governments into groups of connected clients is unwarranted from a risk management perspective, as is recognised through the exemption of exposures to Central Governments from large exposure limits under Article 400(1) and would make the reporting unduly burdensome.

Establishing interconnectedness based on Economic dependency

Question 07: 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.

The 2009 CEBS Guidelines established that there was no requirement to consider clients to be interconnected as long as an institution concluded that the failure of a client would not lead to "substantial, existence-threatening repayment difficulties" of another client. However, the draft guidelines propose to delete the expression "'substantial, existence-threatening" and simply retaining "repayment difficulties". We understand the EBA's intent to achieve a more prudent approach in this area; nevertheless, repayment difficulties should be linked to the intention of the Basel Committee to only capture connections that threaten default.

The Basel Committee's intent is clearly outlined in the BCBS's Standards on 'Supervisory framework for measuring and controlling large exposures'[4] in Paragraphs 1 and 3:

> Paragraph 1 *(except)*: 'Large exposures regulation has been developed as a tool for limiting the maximum loss a bank could face in the event of a **sudden counterparty failure** to a level that does not endanger the bank's solvency.'; and

[4] http://www.bis.org/publ/bcbs283.pdf

> Paragraph 3 *(except)*: 'A large exposures framework complements the Committee's risk-based capital standard because the latter is not designed specifically to protect banks from large losses resulting from the **sudden default** of a single counterparty.'

Furthermore, Paragraph 27 makes it clear that if a counterpart can 'overcome financial difficulties, or even the second counterparty's default, by finding alternative business partners or funding sources within an appropriate time, the bank does not need to combine these counterparts to form a group of connected counterparties.' Thus, the connection is only meaningful to the extent it threatens default.

We recommend, therefore, defining repayment difficulties to be where default of the counterparty is highly probable, which would help ensure dependencies identified are meaningful for the purpose of capturing 'single risk' and limiting loss in the event of a sudden default of a counterparty.

Question 08: 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)?

We believe the situations are helpful for reference purposes, but that it should be made clear that these situations are listed for the purpose of helpful items for consideration, rather than there being a requirement to assess each situation for each possible connection. Reasonable efforts should be made to consider such situations where deemed relevant, but a requirement to assess each situation would result in significant IT investment costs, including costs for storing the relevant information. This is because the requirement will necessitate that banks aggregate information from each of its customer's 'know your customer' databases. Noting that customers may be other internationally active institutions with large customer bases, investigating and maintaining robust information regarding non client related connection information and storing it would be impractical and prohibitive. There is also a cost to customers in that firms will consider themselves compelled to seek very granular information from them regarding their supplier and customer bases in order to properly identify non client entities, which we do not feel is appropriate for the large exposure regime; the large exposures regime is to 'set prudent limits to a single borrower or a closely related group of borrowers'[5] and thus limits its focus to counterparties (clients) and groups of connected counterparties of the institution and not beyond.

Comments on individual situations:

The inclusion of situation 'h' that identifies clients that 'have an identical customer base, consisting of a very small number of customer and where the potential for finding new customers is limited' could lead to whole geographies or sectors being considered a single risk. It is clear from the CRR that these risks fall outside the scope of the large exposures regime as recognised in the consultation paper:

'Geographical and sectoral concentration risks fall outside the scope of the large exposures regime as provided for in Part Four of Regulation (EU) No 575/2013 and are addressed by other means such as the risk management rules on concentration risk under Pillar 2 of the CRD IV'.

We ask that this statement from the consultation paper should be included in the guidelines and believe situation 'h' should be removed from the list or replaced with one that clearly defines what is meant by 'a very small number of customers'.

In relation to situation 'i', we believe it would benefit from specifying a materiality level at which the common shareholding becomes relevant for the purpose of an economic dependency. For instance, two entities which have common shareholders but for which the shareholders interest only constitutes a minority holding in each entity, would not create an economic dependence whereby the failure of one entity results in a high probability of the default of the other. Our previous point on the requirement to treat investment by funds differently also applies in this instance.

[5] http://www.bis.org/publ/bcbs283.pdf - Paragraph 2

Additional guidance would be welcome in relation to indicator 'j' to make clear what aspect of the relationship is important from an economic dependence perspective i.e. the significance of the loan to both parties.

Question 09: 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.

The explanatory box gave the example of a situation 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 example is in contravention to a number of aspects of the large exposures regime. In this example the connection goes beyond the existing 2009 CEBS guidelines of 'substantial, existence threatening repayment difficulties' as well as the more prudent 'repayment difficulties' guidelines proposed in the revisions. In addition, it de-couples the concept of economic dependency constituting a single risk, to indirect contingent dependencies. As such, the scenarios should remain focussed on first order impacts from direct and material dependencies.

Article 403 makes clear that firms are entitled to ignore the existence of guarantees for the calculation of large exposures. It is in our view beyond the remit of the EBA to overrule Level 1 text, which it would do if the mere existence of a guarantor creates a connection.

Question 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.

The concept is clear even if its application is not straightforward, as the assessment of the economic dependency is often not clear-cut because of the high degree of subjectivity and the lack of relevant and definitive information; this has the consequence of 'volatile' reporting of groups' exposures in the LE framework due to the changes in the groups perimeter.

Other Matters

Reasonable Steps

Notwithstanding the matters noted above, it is near impossible to ensure completeness of data and further still, interconnections are likely to change faster than the reporting frequency of data on which banks would be reliant to maintain records. As such, AFME was pleased there was recognition that 'as the determination of economic interconnections is dependent on the one hand on the **information available** to, or gathered on a **best efforts basis** by the reporting institution, and on the other hand on **economic judgement,** it is possible that **different institutions will arrive at different results when analysing the same entities**.' We note the reference to best efforts basis here and the reference to the 'reasonable steps to acquire this information' elsewhere in the paper. As such, we ask the wording is aligned to say 'or gathered on a reasonable efforts basis by the reporting institution'. Best efforts has cost implications as it suggests a materiality threshold for investigation cannot be applied, rather than the intent for processes to be commensurate to the business.

Economic dependency through a main source of funding

We note that there are no changes in the 'Economic dependency through a main source of funding' section of the guidelines. We understand this to mean there is no expectation for institutions to change the way in which they currently comply with the guidelines, particularly as some national authorities have provided detailed guidelines on how to comply with the expectations in this area previously (particularly in regard to the treatment of own firm SPVs).

Explanatory diagrams

As discussed at the EBA Hearing, the diagrams included in the Consultation Paper are viewed as helpful and we ask that these are included within the final Guidelines.

Kind Regards,

Director, Prudential Regulation

Sahir Akbar

<u>**Annex**</u>

All of the scenarios below are to some extent variations on how instances of fund management control should be interpreted.

1. Loan to a CRR regulated Fund Manager or a fund manager under UCITS or AIFD

Some of the large exposure questions this raises are:
- Is this effective "control" intended to be captured by the CRR definition?
- Even if this is not "control", is this considered economic risk, for example from a funding perspective?
- What would the impact be for banks, and the fund management industry, if long-standing approaches were changed to bring such situations into the large exposure regime?

Industry seeks confirmation from the EBA and European Commission that there is no intention of changing long-term practices. A change would have detrimental effects on the asset management industry and create significant regulatory burdens for lenders. The burden is that fund managers will not (and indeed should not for conduct reasons) disclose to their bank the totality of their investments – which would be required for banks to be able to meet the new requirements if such situations are not exempted. We would expect that an aggressive interpretation would mean a significant increase in risk of asset managers, as they will no longer be willing (or able) to rely on banks for their corporate liquidity management.

The situation of a loan to an AIFD fund manager is discussed under 5 below.

The rationale for the exemption is that:
- Fund managers do not have unfettered control.
- There is no single risk, as the underlying companies are not interconnected
- Even in case of default of an underlying exposure, the financial stability of the fund manager is unaffected due to diversification in the breadth of portfolios.

2. Loan to a company where a fund manager (such as AAM) could be seen as "controller" under an aggressive interpretation of the new proposals.

This scenario raises similar questions to the ones under 1.:
- Does this effective "control" by the fund manager mean that a bank would have to go up to the fund manager and down again to all other entities that it may control via its funds in order to meet its obligations under the large exposure requirements?
- Even if this is not "control", is this considered economic risk, for example from a funding perspective?
- What would the impact be for banks, and the fund management industry, if long-standing approaches were changed to bring such situations into the large exposure regime?

Industry seeks confirmation from the EBA and European Commission that there is no intention of changing long-term practices of not including these into the scope of large exposure management. A change would have significant detrimental effect on the industry financing and future economic development. The burden this would require of banks to demonstrate that they have understood all connections at fund managers will not (and indeed should not for conduct reasons) disclose to their bank the totality of their investments – which would be required for banks to be able to meet the new requirements if such situations are not exempted.

The rationale for the exemption is that:

- Fund managers do not have unfettered control.
- There is no single risk, as the underlying companies are not interconnected. There is therefore no risk of contagion.
- Even in case of default of an underlying exposure, the financial stability of the fund manager is unaffected due to diversification in the breadth of portfolios.

3. Loan to a company which is ultimately controlled by a venture capital or private equity firm (jointly called "private equity firms" hereafter).

This section is intended to discuss a situation where a venture capital or private equity firm owns more than 50% of the borrower, either directly or indirectly through a fund in which it co-invests. The example should be viewed slightly differently to the one in section 2, given that generally the business of private equity firms is to have more of an influence on the activities of the companies they invest or co-invest in. Nevertheless accounting standard setters have acknowledged that this is different to a typical parent - subsidiary relationship and have therefore exempted these arrangements from consolidation requirements.

The key considerations are:

- FASB and IASB do not require consolidation of such controlled entities in recognition of the limits to how control is exercised. Is recognition of this approach for large exposure regime acceptable?
- The exemption from consolidation also reflects the lack of single risk. Thus a default of an investee company would not create any contagion to either: the private equity firm, the fund through which it and other investors invest, or other investee companies[6]. There should therefore be no aggregation for large exposure purposes.
- What would the impact be for banks, and the private equity fund management industry, if long-standing approaches were changed to bring such situations into the large exposure regime?

Industry seeks confirmation from the EBA and European Commission that there is no intention of changing long-term practices of not including these into the scope of large exposure management. A change would have significant detrimental effect on the industry financing and future economic development. The burden this would require of banks to demonstrate that they have understood all connections at private equity firms will not (and indeed should not for conduct reasons) disclose to their bank the totality of their investments – which would be required for banks to be able to meet the new requirements if such situations are not exempted.

The rationale for the exemption is that:

- Private equity firms do not have access to investee's assets and liabilities.
- There is no single risk, as the underlying companies are not interconnected. There is therefore no risk of contagion.
- Even in case of default of an underlying exposure, the financial stability of the private equity firms is unaffected due to diversification in the breadth of portfolios.

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[6] This is based on the general approach in the private equity industry that it does not downstream debt into equity. The situation would be different if the private equity firm received loans that it down-streamed to the investee's company as either debt or equity.

4. Loan to a fund (private equity fund or other)

Investments into funds have specific capital requirements under CRR and require look-through for large exposure purposes. The situation is less clear where the exposure is of a different type, such as a loan or counterparty credit risk as a result of a derivative contract with the fund. Such exposures do not impact on the value of the fund's underlying investments and are attributable to the investors in the fund, not the investee companies. As a result it is the industry's view is that

Such a loan to a private equity firm would fall under a shadow banking exposure on the basis that it could be down-streamed to investee companies and therefore represent shadow banking activities. The industry notes that it would only lend to a private equity firm to facilitate its liquidity management, as opposed to enabling leverage of the private equity firm.

Under such circumstances, where there is no leverage brought into the system by lending to a fund it is the industry seeks confirmation that:

- Banks can treat such exposures as a single exposure not requiring look through.
- Banks do not have to look up to investor entities (and particularly not down again) to meet the large exposure requirements.

It has already been noted under 2) that no large exposure aggregation should arise to the fund manager in case the fund manager is acting solely in its capacity as fund manager.

5. Other

These Guidelines do not reference treatment of exposures to trusts. Some national authorities have created specific expectations for these exposures[7]. These expectations are not contradictory to the Guidelines proposed in this consultation, but are instead more prescriptive. As such, we understand the intention is not to change the expectations in these instances and existing treatments should be maintained to comply with local expectations / law.

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Section 23 of Italian Banking Law, Article 2359, Paragraphs 1 and 2, relate to the issue of control and indirect control through trusts.
Section 5 of the PRA's Supervisory Statement on Large Exposures also covers expectations related to 'Exposures to Trustees' : http://www.bankofengland.co.uk/pra/Documents/publications/ss/2013/ss1613.pdf