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FRENCH BANKING FEDERATION RESPONSE TO THE EBA CONSULTATION PAPER ON GUIDELINES ON CONNECTED CLIENTS (EBA/CP/2017/07)

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to share its comment on the EBA's consultation on the definition of "connected clients" under article 4(1) (39) of Regulation (EU) N° 575/2013, and the possibility to answer this consultation **clarifying and operationalising the concept of interconnection**. The challenge faced by the industry is not new and we handle it with the seriousness it deserves.

However, as explained in our response to the previous EBA consultation paper (EBA/CP/2016/09) we consider that the top priority is **to address the main objectives of the regulation**, and **not to get more complex definitions** which might become non applicable.

As explained in our response to the previous consultation paper, if we understand the need to address **the risk of default contagion**, we do not agree with the fact that an **economic dependency or a concentration of funding** established between customers be a stronger dependency relationship than an **ownership relationship**.

It seems necessary to highlight that the economic dependencies criteria brought by the draft guideline on "connected clients" may **damage the capacity for banks to finance European SME** and **the European willingness of "SME Supporting Factor"**.

Furthermore, these guidelines will lead to a **higher level of complexity** in the reporting and will constrain banks to significant operational efforts. Subsequently, we ask the EBA to perform a cost/benefit analysis because the proposed broad scope may lead to costly IT changes. **The FBF asked the EBA to deliver sufficient time to implement any revised framework, at least 18 months after the final guideline publication.**

Please find below our detailed answers to the EBA's questions.

Q1: Do you agree with this approach? Please explain how the application of the draft guidelines with the above amended scope would possibly affect current practices.

Please specify what overall impact the extended scope would have. If relevant, please differentiate between the impact of considering connected clients due to control or connected clients due to economic dependencies.

We appreciate the regulatory efforts to harmonize rules aiming at an uniform application of groups of connected clients beyond the Large Exposure framework. However, we do believe that by construction, the regulatory purposes need to be finely distinguished for some specific area, and this is particularly true regarding European SMEs for which the supporting factor was designed "to allow credit institutions to **increase lending to SMEs following the crisis**, and **to alleviate regulatory changes that were expected to have a disproportionate impact on SME lending**" (as stated in EBA 2016 report).

As a general principle, Large Exposures (LE) framework is a key supervisory **backstop** dealing with single-name **concentration risk**, while the Pillar 1 capital framework is built in a more **granular** manner in order to better take into account specific features relevant to each **exposure class.** Keeping this in mind, we think it is necessary to carefully address the differentiation between the backstop capture of concentration risk based on a sum-up mechanism and the assignment of exposure classification. As explained in our response to the previous EBA consultation paper (EBA/CP/2016/09) we considered that the top priority is **to address the main objectives of the regulation**, and **not to get more complex definitions** which might become non applicable. Even if the "connected clients" concept is covered by liquidity, solvency and Large Exposure topics, the definition must be different between the various risks. We support the initiative to define more precisely the concept of "connected client", but it would be defined differently for "Large Exposures", liquidity and capital requirements. **There should have three different definitions**. Moreover, we do not support a **complex methodology** to identify connected clients. The EBA draft guidelines significantly departs from the Basel definition which states that counterparties are connected **when an ownership relationship exists** between counterparties or customers. Neither common source of funding nor economic dependence (between supplier and customer) **oblige a counterparty to support another one** in a situation where ownership relationship between these entities would not exist. The draft guidelines definition **departs significantly from the Basel standard and are largely more prescriptive than the 2009 CEBS Guideline**. The frequency of changes in economic dependencies would add significant **volatility into Pillar 1 capital requirements**. We ask the EBA to stick to a single and non-prescriptive definition of "connected clients" limited to the ownership connection between two or more legal entities.

We would like to re-iterate our concern and do disagree with the extension of the scope of the economic links from "substantial, existence threatening repayment difficulties" to mere "repayment difficulties" as envisaged in the EBA 2016 consultation on connected clients, and we are concerned that the side effects caused by this change would be even exacerbated due to these draft guidelines. Some adjustments are hence needed in order to avoid unintended consequences. In the context of such current proposal of a broader definition of "economic dependency", economic dependency as a basis of assessing connected clients may create a number of unintended issues:

- High volatility as dependencies change which increase the complexity level for banks taking reasonable steps to acquire such knowledge;

- More seriously a double-inclusion concern: by design as a backstop framework, each group of connected clients is controlled **individually by the LE limit.** However, in the pillar 1 capital framework, as capital requirements resulting from RWEA calculations are added up, the economic dependency may lead to double-inclusion effects, which overstate the risks.

In addition, such undesired capital impacts are likely to disproportionately affect smaller banks. These guidelines will lead to a **higher level of complexity** in the reporting and will constrain banks to significant operational efforts. Subsequently, we ask the EBA to perform a cost/benefit analysis because the proposed broad scope may lead to costly IT changes. **The FBF asked the EBA to envisage sufficient time for allowing banks to implement any revised framework, at least 18 months after the final guideline publication.**

As we had indicated in answer to the 2016 consultation (EBA/CP/2016/09) on Guidelines on "connected clients" for Large Exposure, banks will face **major operational issues** if the notion of interconnection due to economic dependency is to be systematically applied as defined in the Guidelines. We advocate that should this type of connection be kept, the identification process should remain **non-prescriptive and based on an expert analysis**, **on a case by case basis**. A "systematic" identification process (with each criteria detailed in the 2016 guidelines consultation automatically leading to the existence of a group of connected clients) could lead to misleading results, as automatic application of those criteria does not necessarily reflect the existence of a single risk. We also favor that the requirement to identify economic dependencies not be extended to beyond an institution's client base.

A broader application of the economic dependency criteria would involve **a significant operational effort** by banks as the **number of groups of connected clients may increase substantially**. Clear instructions and definitions which are operationally manageable are needed. In addition, the purpose of linking clients through connected groups is **not the same for the different CRR articles relating to this notion**, therefore strictly applying the 2016 guidelines does not necessarily makes sense. The "groups of connected clients" referred to in the large exposures section is meant to avoid over concentration in those groups while the same notion referred to in most of the other articles of CRR, is meant to categorize the clients in different exposure classes receiving different regulatory capital or liquidity treatments. This also advocates not to extend the scope of application the 2016 Guidelines.

Q2: Please explain how the application of the draft guidelines on connected clients would possibly change current practices regarding the categorisation of retail exposures?

What is the likely impact of applying the draft guidelines on connected clients to the categorisation of clients in the retail exposure class (Article 123(c) and Article 147(5)(a)(ii) of the CRR)? If there is an impact, please provide concrete examples and both qualitative and quantitative information, specifying whether the impact is related to the Standardised Approach or the IRB Approach for credit risk.

As indicated in the answer to Q1, the risk of a disqualification of retail exposures class due to connected clients **might only be justified by ownership relationship between counterparties**, and neither by economic dependencies (neither financial nor commercial), nor by automatic criteria.

Extending the scope of connected clients would **reduce the ability for banks to benefit from the retail RW for their SME exposures.** Moreover, it would imply significant changes in banks' internal models, at least those used for large corporate as this category would consequently cover a wider population, with new features. Those model changes being material, they would have to be addressed through the new ECB model validation process. It is also to be noted that, as the population covered by the modified models is to be less homogenous, the precision of the models would be of lesser quality. Furthermore, it should be clarified that group of "connected clients" **can only concern SMEs** (as indicated in article 147(5) (a) (ii)) and **not natural persons**.

The application of the "connected client" framework to the proposed extended scope would impact the retail classification. Retail exposures, in particular SME exposures would more easily breach the EUR 1 million threshold to be classified into the retail category. For example, an exposure to a small supplier below EUR 1 million could no longer be classified in the retail category if this supplier is considered to be connected to a large corporate. If the inclusion of such economic relationship would be imposed, we would like to ask for at least a regulatory revision of the "1 million" threshold accordingly. It is noteworthy that the 75% risk weight associated to retail exposures is justified by the diversification effect on a portfolio level. Indeed, on a portfolio level, it is very unlikely that all the retail exposures get into difficulties simultaneously, which justifies the application of a lower risk weight than the ones that applies for corporates. We believe it is inappropriate to contaminate the retail classification with exposures of non-retail nature. It is worth mentioning one more concern for international banking groups, if the assessment requirement including such "customer-supplier" kind economic relationship would have to involve multiple countries. The overly complex level of such cross-border economic relationship would by construction introduce a new regulatory risk to banks, which are required to appropriately determine the Retail / Corporate classification frontier.

In addition, the FBF would like to note that extending the scope of the definition of connected clients to retail clients raises legal, operational and system related issues. In particular**, information sharing** between companies and jurisdictions is not straightforward for **data protection reasons** and due to the **differences between the legal frameworks**. This would particularly penalise cross-border banks which would have to implement information sharing systems across the borders.

Example :

The consultation does not clarify how **potential double-inclusion effect of "connected clients"** shall be avoided in capital computation. In the following example, C is economically dependent from A and B (with no connexion between A and B), therefore, according to the Guidelines, 2 groups of "connected clients" should be formed (A+C and B+C)

That overlapping is not problematic for Large Exposures, as the large Exposure limit applies individually to each group. However, for the retail exposure categorization purposes, taking into account all different groups of connected clients would lead to an undesired double counting effect of C in capital computation.

Q3: Do you agree with the EBA's assessment that there would be no impact of applying the draft guidelines on connected clients to development and application of the rating systems (Article 172(1)(d) of the CRR)?

We welcome the EBA's statement of its view on this question, as the CRR in article 172(1)(d) clearly requires that a **separate rating** shall be provided to each separate legal entity and that institutions shall have appropriate policies regarding the treatment of groups of connected clients.

But we don't agree on the EBA's assessment of an absence of impact, as we are more concerned that the inclusion of economic dependencies would lead to an unjustified double counting effect of entities across multiple aggregated groups. **Current practices takes in account the existence of connection based on economic dependencies on a case by case basis** with expert analysis (or in a semi-automatic approach) for both rating analysis and default definition. The monitoring of connected clients in the IT systems would be unduly burdensome with **no significant improvement in the results** of the risk profile assessment. Applying the 2016 guidelines will necessarily have impacts on the development and application of the rating systems. Also note that the GL on the definition of default is applicable for 2021: therefore banks could not be expected to be compliant as of today.

Also as a client could be connected within various groups, again banks will face an issue of what economic dependency to take into account for the purpose of ratings, which can furthermore increase the disparity of treatment. In addition, **there may be cases where clients are connected, however each financial profile of each client may differ strongly implying distinct risk profiles**: there is therefore no evidenced extension of a single rating to the whole group of connected clients.

In addition, we expect that **an exhaustive identification of "connected clients" to be impossible in practice** (for all the clients in a portfolio, studying the connection of a client in our portfolio with all the other clients within this same portfolio).

In practice, we are concerned that the counterparty rating assessment would be extended to a larger number of entities included in the group concept due to a broad economic connection, therefore impacting the appropriateness of the rating on a single obligor and consequentially the applicable pricing and the relative capital absorption. The link between default event and information on economic links will likely weaken given the extension of the rating assignment perimeter, embedding the group link function to a broad range of obligors.

Q4: Please explain how the application of the draft guidelines on connected clients would possibly change current practices regarding the use of the SME supporting factor?

What is the likely impact of applying the draft guidelines on connected clients to the SME supporting factor (Article 501(2)(c) of the CRR)? If there is an impact, please provide concrete examples and both qualitative and quantitative information.

Extending the scope of "connected clients" would **damage the benefit of the supporting factor for qualified SME exposures**, which is by design very detrimental for the financing of the European real economy.

The SME supporting factor is with no doubt an incentive to grant financing to SMEs, which are reputed as having limited access to funding. It was introduced in 2013 European "Capital Requirement Regulation" with the aim of providing an adequate flow of new credit to SMEs. The introduction of the "SME supporting factor" into the European legislation is considered as an important element to promote financing to SMEs which are **a key driver of economic growth and job creation**. All in all, the application of the guidelines to the current practices regarding the use of the "SME supporting factor" could **jeopardize the effectiveness of the "SME supporting factor".**

Similar to the issues raised for retail exposures, there will be undesired breach of the EUR 1.5 million threshold due to the inclusion of a broad economic relationship. Therefore, inflating SMEs exposures would remove the supporting factor benefit at this early stage of the economic recovery, therefore would not be justified.

As indicated in the answer to Q1, the disqualification of the "SME Supporting Factor" categorisation due to "connected clients" **might only be justified by ownership relationship between counterparties**, and not by economic dependencies (neither financial nor commercial).

Again, the issue of the application of the 2016 Guidelines can be questioned as, we understand the reference to group of "connected clients" is meant to categorize SME vs corporate. Banks will face the issue of overlapping group of "connected clients".

For these reasons, we suggest to the EBA to follow a consistent approach with **the review of CRR/CRD** currently taking place at European level, where **the "SME supporting factor" would be applicable for all levels of exposures.**

Q5: Please explain how the application of the draft guidelines on connected clients would possibly change current practices regarding the reporting to competent authorities, for instance in the area of liquidity?

What is the likely impact of applying the draft guidelines on connected clients to reporting requirements, where relevant? If there is an impact, please provide concrete examples and both qualitative and quantitative information.

1) <u>NSFR reporting impact associated to CRR Article 428 (1) (g) ii</u>

According to this article, in order to categorise retail exposures we should take into account **the amount of aggregate deposits** placed by client or group of connected clients (<= 1 MEUR). We suggest not to apply the 2016 Guidelines to article 428 (1) g (reporting issue) as CRR2 NSFR (draft) **does not mention group of “connected clients”** when it comes to categorizing loans from retail clients.

In addition to that, when it comes to maximum amount of aggregate deposits placed by a client there seems to be **a confusion within the CRR between**:

- “**group of connected clients**” mentioned in CRR article 428 (1) (g) (ii)
- “**group basis**” mentioned in CRR article 411 (Liquidity Definitions), Retail deposits categorization for liquidity purposes require to take in account the amount of aggregate deposits placed by client on a group basis (<= 1 MEUR).

2) <u>C67 & C71 AMM Reporting</u>

ALMM Template 67: Concentration of funding by counterparty. The concentration ratios may increase if some counterparties are included in a group of connected clients.

ALMM Template 71: Concentration of counterbalancing capacity by issuer. The concentration ratios may increase if some counterparties are included in a group of connected clients.

3) <u>Compliance reporting for LCR and NSFR</u>

In addition to the reporting impact mentioned in the consultation, the extension of the 2016 Guidelines will also have a ratio impact on LCR and NSFR.

Article 3 of Delegated Act on LCR gives following definitions [1] : *‘retail deposits’ means a liability to a natural person or to an SME, **where the SME would qualify for the retail exposure class under the standardised or IRB approaches for credit risk**, or a liability to a company which is eligible for the treatment set out in Article 153(4) of Regulation (EU) N° 575/2013, and where the aggregate deposits by such SME or company on a group basis do not exceed EUR 1 million;*

[1] To be noted that there is a current discrepancy between CRR “retail deposits” (article 411) and LCR Delegated Act “retail deposits” definition

As **the retail exposure** categorisation for credit risk **will be impacted** by the application of the Guidelines, there will accordingly have **an impact on LCR/NSFR** reporting and /or requirement.

The same issue than those mentioned before (operational constraints, undue ratio decrease linked to connections limiting the application of the retail deposits treatment, overlapping between groups etc) will occur.