

Comments

RTS on groups of connected clients

Lobby Register No R001459

EU Transparency Register No 52646912360-95

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Berlin, 7 September 2022

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Questions

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.

According to the consultation draft, the guideline requirements in sections 4, 6 and 7 were to be fully transposed into the RTS. However, these requirements have been tightened – even though according to the executive summary of the consultation draft these were to be transposed “without substantial changes”. In particular, circumstances that may lead to a group of connected clients due to economic dependencies are in danger of losing their indicative character due to the wording chosen in Article 2(1) (see question 5) and becoming circumstances in which a group of connected clients would be formed mechanistically, with no case-by-case assessment. In our opinion, Article 2(2) of the RTS does not fit with the concept of a single risk due to economic dependency, which is established subject to an individual case review based on at least the circumstances set out in paragraph 1, and is superfluous in our view. Either there is a single risk due to economic dependency or there is not. In our opinion, there is no scope to refute the single risk where one or more of the circumstances outlined in paragraph 1 is affirmed.

These RTS would indeed incur implementation costs due to the required technical changes and amendments to the banks’ documentation and processes. This should be avoided where possible.

We welcome the fact that the guidance on the alternative approach for exposures to central governments and supervisory expectations with regard to control and management procedures for identifying connected clients will stay in the guidelines as well as all the illustrative examples. The EBA is thereby following its mandate by drafting the RTS in line with Article 4(4) of the CRR. It must be ensured that there are no discrepancies between the RTS and the guidelines in the examples of the circumstances regulated in the RTS, including in the explanations.

With respect to the illustrative examples in the RTS we have the following remarks:

1) Scenario C 1, paragraph 51 i)-iv): We would like to suggest further clarifying letter i) by amending the paragraph as follows: “The absence of economic interdependence or any other factors that could be indicative of ~~aa material positive correlation~~ **risk of contagion** between the credit quality of the parent undertaking A and the credit quality of the SPE/SPV (B, C or D). Among other factors, the absence of a potential reliance on parent undertaking A for funding sources and circumstances of deconsolidation of the SPE/SPV under the applicable accounting rules have to be assessed as potential signs of economic independency.

The current wording is ambiguous because the word “correlation” is a statistical term. The concept of a single risk, however, is based on the risk of contagion between clients that are exposed to the same idiosyncratic risk factor.

2) Scenario E 7, paragraph 65: The wording “it cannot be ruled out” means that if the existence of a single risk cannot be refuted (following a potentially exhaustive and documented examination) it must be

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assumed that there is a single risk and therefore a grouping requirement due to economic dependency. (Burden of proof lies with the bank). This represents a tightening of the current regulations. In our opinion, the economic dependency between P1 and P2 must be neither ruled out nor refuted. Since P1 and P2 are borrowers, the economic dependency relationship of P1 and P2 must be actively examined. If it is determined upon examination that P1 is economically dependent on P2, then there is a grouping requirement. The wording "if it cannot be ruled out" should therefore be changed to "if it can be assumed that there is an economic dependency between P1 and P2".

3) Scenario E 7, paragraphs 64 and 65: The scenarios in paragraphs 64 and 65 are based on the basic example in paragraph 63, i.e. they assume that P1 and P2 each hold 50% of shares in the respective companies. We believe the links between P2 and A/B/C are missing in the diagrams in paragraphs 64 and 65. If these are not shown for reasons of clarity, then this should be made clear with a comment or footnote. In addition, the companies in paragraph 64 are falsely labelled B/C/D when, in fact, they should be labelled A/B/C (thereby corresponding to the description in paragraph 65).

4) Scenario E 8, paragraph 67: The current indicator for an economic dependency due to management on a unified basis has now been turned into a mandatory requirement with the wording "needs to be formed", contrary to recital 6: "that at least should be considered" (see also our answer to question 5). Furthermore, these circumstances do not need to be illustrated with an example as this would not provide any additional insight. The reference to paragraph 7 of Article 22 of Directive 2013/34/EU is somewhat confusing here.

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.

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.

Article 1(2)(c) should be limited to cases in which natural or legal persons are in a position to exercise dominant influence over other legal persons. Otherwise, the questions become about legal relationships between natural persons (guardianship, care, trusteeships, execution of wills etc.) which have nothing to do with the control concept in terms of connected clients. We therefore propose changing the wording of Article 1(2)(c) as follows:

"the natural or legal person is in a position to exercise dominant influence over another legal person or legal persons pursuant to a law or contract, or provisions in memoranda or articles of association;"

We assume that use of the phrase "may be deemed" means that the criteria set out in Article 1(3) continue to represent indicators of a control relationship.

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In line with the current guidelines and taking into account the points outlined above on the relationship between two natural persons, we propose that the indicators of a control relationship in Article 1(3) be worded or amended as follows:

- “(a) the natural or legal person **has the power to decide** ~~decides~~ on the strategy or *to direct* ~~directs~~ the activities of another **legal** person or **legal** persons;
- (b) the natural or legal person **has the power to decide on crucial** ~~decides on important~~ transactions, such as the transfer of profits or losses of another **legal** person or *legal* persons;
- (c) the natural or legal person has the right or ability to coordinate the management of one or more ~~natural or legal~~ persons **in pursuit of a common objective.**”

Some NCAs require that banks include their subsidiaries in a group of connected clients due to the control relationship. In our response to question 6 of the EBA’s “Questionnaire on aspects concerning the development of the draft RTS on GCC” from December 2021, we were critical of this point and asked for clarification. The present consultation paper EBA/CP/2022/07 addresses this aspect in paragraph 41 by referring to Article 1(1) of the draft RTS, which does not answer our original question satisfactorily. We would ask for clarification as to whether it is necessary to form a group of connected clients here for the following reason: In the fourth paragraph of chapter 2 on page 4 of this consultation paper, it states that idiosyncratic risk that makes the formation of a group of connected clients necessary, “arises where, because of specific circumstances of bilateral interrelationships, [the] financial problems of one entity can be transferred to another entity. There is no such bilateral interrelationship between the subsidiaries of a bank, the only link is via the institution itself. As a result, the bank acts as the main risk-driver, requiring the formation of a group of connected clients. In economic terms, this results in a circular argument with regard to the supervisory purpose of the formation of a group of connected clients: If the legally determined credit risk concentration materialises in this constellation, the institution itself, as the main risk driver, is assumed to already be in financial difficulties. A credit risk concentration materialising from a group of connected clients, consisting of the bank itself and its subsidiaries, can no longer bring the bank under consideration into financial difficulties, as it is assumed to already be in such difficulties.

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?

The scenario is sufficiently clear. In our opinion, there is no need for further illustrative examples.

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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.

We would recommend retaining the wording of the guidelines, which guarantees a risk-appropriate case-by-case assessment. As we understand it, the RTS take the approach that a single risk should normally be assumed to exist in the circumstances set out in Article 2(1)(a) to (j). This assumption can only be rejected in exceptional cases. Firstly, this is at odds with existing practices since paragraph 23 of the current guidelines say: "Institutions should consider, in particular, the following situations when assessing economic dependency:". Second, the proposed RTS frequently fly in the face of practical experience. Economic dependency by no means always exists in all the circumstances mentioned. The described circumstances therefore lend themselves to use as examples, but not de facto assumptions.

As we see it, the indicative nature of the signs of economic dependency would be turned into binding criteria, especially given the proposed wording in Article 2(1). This would encourage a mechanistic application, which would run counter to a risk-appropriate case-by-case analysis of economic dependency.

The description of the circumstances, by contrast, use indeterminate terms such as "significant" (c, d, e) and "excessively" (c, d, f, h), which, in line with current practices, again point to a case-by-case assessment. In our view, all circumstances should continue to be seen as possible indications only.

We therefore suggest rewording Article 2(1) as follows:

"Two or more natural or legal persons constitute a single risk because of **economic dependency** if they are interconnected in a way that, where one of them were to experience financial problems, in particular funding or repayment difficulties, the other, or the others would also be likely to encounter financial problems.⁷ **Institutions should consider in** at least the following circumstances **when assessing economic dependency:**"

With respect to the circumstances mentioned in point (a), we believe that these are already covered by the general definition of single risk due to economic dependency ("*Two or more natural or legal persons constitute a single risk because they are interconnected in a way that, where one of them were to experience financial problems, in particular funding or repayment difficulties, the other, or the others would also be likely to encounter financial problems, in at least the following circumstances:*"). They do not, in our view, describe a separate type of economic connection but are a consequence of the economic connection or dependency when the single risk materialises.

As to the circumstances in point (i), please see also our comments under no. 4) of our reply to question 1.

We would like to point out with regard to point (j) that it is unclear what the inclusion of the terms "common owners, managers or shareholders" is intended to achieve. We see no need for them since the term "persons" already covers the additional categories mentioned. Furthermore, the term "administrative management body" is not normally used when formulating prudential requirements, in our view. The Capital Requirements Directive, for instance, defines only the term "management body" in Article 3(1)(7).

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We therefore recommend rewording point (j) as follows:

Where the **administrative** management or supervisory bodies of two or more legal persons consist for a major part of the same persons, ~~common owners, managers or shareholders.~~

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.

At first glance, introducing a threshold would seem to have the advantage of greater clarity and of ensuring more consistent application across the EU. But there would be a danger that economic dependency would no longer be identified on a case-by-case basis but that groups of connected clients would be formed mechanically by applying predefined thresholds. This would not be appropriate, in our view. Rigid thresholds would make it more difficult to detect actual concentration risk. Economic dependency should continue always to be analysed on an individual basis. After all, even if the threshold were met, this would not necessarily mean that the counterparty would default. Dependency may exist if the proportion of gross receipts and expenditures is less than 50%, even though this case is rather exceptional. And if the figure is above 50%, it may still be possible to reject the idea of dependency because the replaceability criterion is met.

The inability to adequately validate thresholds also makes them an unsuitable means of identifying dependency. On top of that, their blanket application would render them arbitrary: too often, they would simply not be able to accommodate a specific case. We therefore recommend retaining the term "significant" and continuing to use the circumstances described as possible indications of economic dependency.

Furthermore, experience has shown that a company's contribution to operating income can also allow conclusions to be drawn about the existence of a single risk due to economic dependency. Therefore, the contribution to operating income can be used as an alternative to the consideration of gross receipts and gross expenditures associated with a customer. In practice, the proportion of gross receipts or gross expenditures may amount to 50% or more without giving rise to single risk due to economic dependency because the contribution to operating income resulting from these transactions is not significant and the client could easily cope with the loss of these transactions following the default of another client.

We therefore suggest amending Article 2(1)(c) as follows:

"where a significant part of a natural or legal person's gross receipts or gross expenditures, **or alternatively its contribution to operating income therefrom** is derived from transactions with another natural or legal person that cannot be replaced in a timely manner without excessively increased costs;"

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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.

We basically welcome the amended wording as it is now a bit more specific and would be easier to operationalise. It is sufficiently open to allow it to be applied to specific individual cases and used as a basis for their analysis. This criterion should nevertheless also be seen as indicative, and not as proof, of economic dependency. We consider it is more appropriate in general to formulate criteria for identifying economic dependency as indicators.

In our view, however, there may also be scenarios where replacement in a timely manner will only be possible **with** excessively increased costs but where these increased costs will not cause significant financial difficulties because compensation can be obtained. In such cases, no single risk can be deemed to exist.

It is therefore vital that institutions pay due regard to the phrase “*cannot be replaced in a timely manner without excessively increased costs*” as it might still be possible for a legal person to easily (i.e. in a timely manner while experiencing increased costs) find a replacement or compensate for any losses (or foregone profits) inflicted by the party in financial difficulties without experiencing repayment difficulties of their own, in which case the institution does not need to consider these companies/persons a single risk.

To also cover these cases, we recommend amending the wording as follows: “that cannot be replaced in a timely manner without excessively increased costs **leading to significant financial difficulties;**”

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.

See our reply to question 1. In addition, we consider Scenario E8 sufficiently clear. We see no need for further illustrative examples.

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.

The described circumstances are in principle sufficiently clear. It nevertheless remains unclear why a rejection of the existence of a single risk within the meaning of Article 1 or Article 2 of the RTS (regarding Art. 2 see also our reply to question 1) should be disregarded. We see no objective reason to deviate from the guidelines in this respect. Institutions should be able, as before, to first determine which clients are connected by virtue of a control relationship and which are connected by a virtue of economic dependency and then assess whether the identified clients should form a group of connected clients.

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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.

The example is sufficiently clear. But it should remain clear in future that an understanding of the interaction between control and economic dependency is the decisive factor in determining whether a group of connected clients should be formed and that this understanding cannot be replaced by individual scenarios.