Final Guidelines on connected clients

European Banking Authority (EBA)

www.managementsolutions.com

Index

Introduction

In November 2017, the EBA published Final Guidelines on connected clients aiming at identifying all possible connections among clients, in particular when control relationships or economic dependency should lead to the grouping of clients as they constitute a single risk

Introduction

In December 2009 the Committee of European Banking Supervisors (CEBS) published the Guidelines on the implementation of the **revised large exposures regime**, with the aim of ensuring harmonised implementation across the Member States. Those Guidelines focused on the definition of connected clients, in particular, control and economic interconnections.

Furthermore, in 2013 the European Parliament and the Council published the **Capital Requirements Regulation** (CRR) which defined the group of connected clients with the objective of identifying clients so closely linked by idiosyncratic risk factors that it is prudent to treat them as a single risk.

- In this context, in November 2017, the EBA published **Final Guidelines (GL) on the treatment of connected clients**, which replace the CEBS Guidelines, aiming at supporting institutions in identifying all possible connections among their clients, in particular when control relationships or economic dependency should lead to the grouping of clients because they constitute a single risk.
- These GL focus exclusively on the **issue of connected clients** as defined in the CRR, and apply to all areas of the CRR where the concept of group of connected client is used (e.g. large exposures regime, the categorisation of clients in the retail exposure class for the purposes of credit risk, the development and application of rating systems, the specification of items requiring stable funding for reporting purposes, and the SME supporting factor) including the EBA technical standards and the EBA guidelines that refer to that concept.
- Moreover, these GL cover the following aspects:
    - Groups of connected clients based on control.
    - Alternative approach for exposures to central governments.
    - Establishing interconnectedness based on economic dependency.
    - Relation between interconnectedness through control and interconnectedness through economic dependency.
    - Control and management procedures for identifying connected clients.

This **Technical Note** summarises the EBA Final Guidelines on connected clients.

Index

Executive summary

Guidelines contents

These GL cover the groups of connected clients based on control, the approach for exposures to central governments, the interconnectedness based on economic dependency, the control and economic dependency interconnectedness, and the control and management procedures

Executive summary

Scope of application	Regulatory context	Next steps
• **Competent authorities** and **financial institutions** (i.e. credit institutions, investment firms, and financial conglomerates)	• **Guidelines on large exposures** (CEBS, Dec. 09) • **CRR** (European Parliament and Council, Jun.13).	• These GL apply from **1 January 2019**, and will repeal the CEBS GL on the implementation of the revised large exposures regime.

Main content

Groups of connected clients based on control	• The GL clarify the concept of ‘single risk’ and confirm that the burden of proof is on institutions to demonstrate that, despite the existence of a control relationship, the clients, by way of exception, do not constitute a single risk.
Alternative approach for exposures to central governments	• The GL clarify the use of an alternative approach, introduced by the CRR, for the assessment of the existence of groups of connected clients of entities directly controlled by or directly interconnected with central governments[1].
Establishing interconnectedness based on economic dependency	• The GL confirm the requirement to consider two or more clients a single risk when funding or repayment difficulties of one client are likely to affect other clients. However, institutions could demonstrate that the failure of a client would not affect another client.
Relation between interconnectedness via control and economic dependency	• The GL also provide guidance on the assessment of situations where control and economic dependency are interlinked and can therefore lead to the existence of one group of connected clients as opposed to two separate groups of connected clients.
Control and management procedures for identifying connected clients	• The GL expect institutions to identify all control relationships and also to take reasonable steps and use readily available information to investigate and identify economic dependencies among their clients.

(1) Or regional or local governments to which the CRR applies.

Index

Detail

Groups of connected clients based on control

These GL clarify the concept of single risk and that institutions should make use of their clients' consolidated financial statements when assessing connections based on control and provide a non-exhaustive list of criteria and indicators of control

Group of connected clients based on control

Concept of single risk

- Institutions are required to assume that two or more clients constitute a **single risk** when there is a **control relationship between them**.
- In exceptional cases, where institutions are able to demonstrate that **no single risk exists** despite the existence of a control relationship among clients, institutions should **document the relevant circumstances** that justify this case in a detailed and comprehensive manner (see scenario C 1 in the annex).

Concept of control

- Institutions should apply the concept of control as defined in the CRR depending on the rules used by clients when preparing their consolidated financial statements:
  - **Directive 2013/34/EU**[1]. Institutions should rely on the control relationship between a parent undertaking and its subsidiaries within the meaning of the Directive (and to the national rules that transposed it), and should group clients accordingly on the basis of their clients' consolidated financial statements.
  - **International accounting standards**. Institutions should rely on the control relationship between a parent undertaking and its subsidiaries within those standards adopted by EC Regulation No 1606/2002 and should group clients accordingly on the basis of their clients' consolidated financial statements.
  - **Accounting rules of a third country**. Institutions should deem to be control relationships those between any natural or legal person and an undertaking that are similar to the parent undertaking/subsidiary relationships above mentioned.

Criteria on control

- When conducting the assessment, institutions should deem any of the following **criteria to constitute a control relationship**:
  - Holding the **majority** of the shareholders' or members' **voting rights** in another entity.
  - Right or ability to **appoint or remove a majority of the members** of the administrative, management or supervisory body of another entity.
  - Right or ability to exercise a **dominant influence** over another entity pursuant to a contract, or provisions in memoranda or articles of association.
- **Other possible indicators of control** that institutions should consider are, among others, the power to decide on the strategy of an entity, or holding more than 50% of the shares of capital of another entity.

(1) Directive 2013/34/EU of the European Parliament and the Council on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings.

Detail

Alternative approach for exposures to central governments

The GL clarify the use of an alternative approach, introduced by the CRR, for the assessment of the existence of groups of connected clients of entities directly controlled by or directly interconnected with central governments, regional or local government to which the CRR applies

Alternative approach for exposures to central governments

Alternative approach

- Institutions may assess the existence of a group of connected clients **separately for each of the persons directly controlled by or directly interconnected with the central government** (alternative approach), in line with the definition of group of connected clients under the CRR.
- The same provision allows for a **partial application of the alternative approach**, assessing separately the natural or legal persons directly controlled by or directly interconnected with the central government (see scenario CG 1 in the annex).
- The provision also makes clear that:
  - The **central government** is included in each of the groups of connected clients identified separately for the natural or legal persons directly controlled by or directly interconnected with the central government (see scenario CG 2 in the annex).
  - Each **group of connected clients** includes also persons controlled by or interconnected with the person who is directly controlled by or directly interconnected with the central government (see scenario CG 3 in the annex).
- Where the entities directly controlled by or directly interconnected with the central government are **economically dependent** on each other, they should form separate groups of connected clients (excluding the central government), in addition to the groups of connected clients formed in accordance with the alternative approach (see scenario CG 4 in the annex).
- Further, these provisions are also applicable to **regional governments or local authorities** to which CRR applies, and natural or legal persons directly controlled by or interconnected with these regional governments or local authorities.

Detail

Establishing interconnectedness based on economic dependency

These GL establish that institutions should take into account whether the financial difficulties or the failure of a client would lead to funding or repayment difficulties for another client when assessing interconnectedness among their clients based on economic dependency

Establishing interconnectedness based on economic dependency

Economic dependency relationship

- Institutions should consider specific circumstances of each case, in particular **whether the financial difficulties or the failure of a client would lead to funding or repayment difficulties for another client** when assessing interconnectedness among their clients based on economic dependency (see scenarios E1, E2, E3 and E4).
- Where an institution is able to demonstrate that the financial difficulties or the failure of a client would not lead to funding or repayment difficulties for another client, **these clients do not need to be considered a single risk**.
- In addition, two clients do not need to be considered a single risk if a client is economically dependent on another client in a limited way, meaning that the client can easily **find a replacement for the other client**.

Assessment of economic dependency

- Institutions should consider, in particular, that exists **economic dependency where**[1]:
  - A client has **fully or partly guaranteed the exposure** of another client and the exposure is so significant for the guarantor that the guarantor is likely to experience financial problems if a claim occurs.
  - A client is **liable as a member in an entity** and the exposure is so significant for the client that the client is likely to experience financial problems if a claim against the entity occurs.
  - A significant part of a **client's gross receipts or gross expenditures** (on an annual basis) is derived from transactions with another client that cannot be easily replaced.
  - A significant part of a **client's production/output is sold to another client** of the institution, and the production/output cannot be easily sold to other customers.
  - The expected source of **funds to repay the loans of two or more clients is the same** and none of the clients has another independent source of income from which the loan may be serviced and fully repaid.
  - The clients are **legally or contractually jointly liable** for obligations to the institution.
  - A **significant part of the receivables or liabilities** of a client is to another client.
  - The clients have **common owners, shareholders or managers**.
- Additionally, institutions should consider situations where the **funding problems of one client are likely to spread to another** on account of a one-way or two-way dependency on the same funding source (see scenarios E5 and E6). In this regard, institutions should assess any contagion or idiosyncratic risk that could emerge from: i) the use of one funding entity that cannot be easily replaced; ii) the use of similar structures; and iii) the reliance on commitments from one source (e.g. guarantees), taking into account its solvency.

(1) Institutions should also consider this non-exhaustive list when assessing connections among shadow banking entities.

Detail

Interconnectedness through control and economic dependency

These GL also provide guidance on the assessment of situations where control and economic dependency are interlinked and can therefore lead to the existence of one group of connected clients as opposed to two separate groups of connected client

Interconnectedness through control and economic dependency

Control or economic dependency

- Institutions should first identify which clients are **connected via control** (control group) and which clients are connected **via economic dependency** in accordance with the CRR.
- Institutions should assess whether the **identified groups** of connected clients need to be (partially) **connected themselves** (e.g. whether groups of clients connected on account of economic dependency need to be grouped together with a control group).
- In their assessment, institutions should consider each case separately, i.e. identify the **possible chain of contagion** (domino effect) based on the individual circumstances (see scenarios C/E 1 and C/E 2 in the annex).
- Where clients that are **part of different control groups are interconnected via economic dependency**, all entities for which a chain of contagion exists need to be grouped into **one group of connected clients**. In this regard, two different types of contagion exist:
    - **Downstream contagion** should always be assumed when a client is economically dependent and is itself the head of a control group (see scenario C/E 3 in the annex).
    - **Upstream contagion** of clients that control an economically dependent entity should be assumed only when this controlling client is also economically dependent on the entity that constitutes the economic link between the two controlling groups (see scenario C/E 4 in the annex).

Control and management procedures for identifying connected clients

Finally, these GL set out control and management procedures for identifying connected clients in order to allow the institution to address all possible connections among its clients to have a clear understanding of the risks it is exposed to

Control and management procedures for identifying connected clients

Control and management procedures

- Institutions should have a thorough **knowledge of their clients** and **their clients' relationships**, and ensure that their staff understand and apply these GL.
- Identification of possible connections among clients should be an **integral part of an institution's credit granting and surveillance process**. The management body and senior management should ensure that adequate processes for the identification of connections among clients are documented and implemented.
- Institutions should identify all **control relationships** among their clients and document as appropriate, and also investigate and document as appropriate any potential **economic dependencies** among their clients. They should take reasonable steps and use readily available information to identify these connections (e.g. because of the existence of a public register).
- The efforts that institutions put into the investigation of economic dependencies among their clients should be **proportionate to the size of the exposures**. Therefore, institutions should strengthen their investigations in all cases where the sum of all exposures to one individual client exceeds 5% of Tier 1 capital[1].
- To assess grouping requirements based on a combination of control and economic dependency relationships, institutions should **collect information on all entities forming a chain of contagion**. Institutions might not be able to identify all clients that constitute a single risk if there are interconnections that stem from entities that are not in a business relationship with the institution and are therefore unknown to the institution (see scenario Mm 1 in the annex). If an institution becomes aware of **interconnections via entities outside its clientele**, it should use this information when assessing connections.
- Control and management procedures for identifying connected clients should be subject to **periodic review** to ensure their appropriateness. Institutions should also monitor changes to interconnections, at least in the context of their periodic loan reviews and when a substantial increase to a loan is planned.

(1) The threshold refers to the institution's Tier 1 capital for the purposes of applying these GL on an individual basis. The threshold refers to the Tier 1 capital of the group of the institution for the purposes of applying these GL on a subconsolidated or consolidated basis.

Index

Next steps

These GL will apply from 1 January 2019 and the CEBS Guidelines on large exposures will be repealed from 1 January 2019

Next steps

- These GL apply from **1 January 2019**.
- The CEBS Guidelines on the implementation of the revised large exposures regime, of 11 December 2009, will be repealed with effect **from 1 January 2019**.

Index

Groups of connected clients based on control

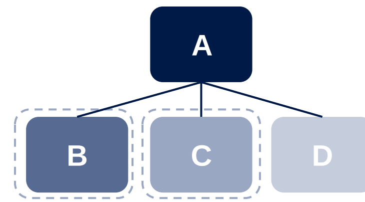
These scenarios illustrate the application of the GL to groups of connected clients under the definition of the CRR, from the perspective of the reporting institution. The C1 scenario is for exceptional cases where no singe risk exists despite the existence of control

Group of connected clients based on control

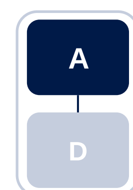
Scenario C 1

Exceptional case (no single risk exists despite the existence of control)

- The reporting institution has exposures to all entities shown (A, B, C and D). Entity A has control over entities B, C and D. The subsidiaries B, C and D are special purpose entities (SPEs) / special purpose vehicles (SPVs).
- To assess if there is no single risk, despite the existence of a control relationship, the reporting institution should assess at least all of the following elements in relation to each of the SPEs/SPVs:
    - The **absence of economic interdependence** or any other factors that could be indicative of a material positive correlation between the credit quality of the parent undertaking A and the credit quality of B, C or D.
    - The **specific nature of the SPE/SPV**, especially its bankruptcy remoteness.
    - The **structural enhancement in a securitisation**, and the delinkage of the obligations of the SPE/SPV from those of parent undertaking A, in the transactions documentation.
    - The compliance with the provisions under the CRR regarding **arm's length conditions** (implicit support).



- Having assessed all of these elements, the reporting institution could conclude that, for example, subsidiaries B and C do not constitute a single risk with parent undertaking A. As a result, the reporting institution needs to consider a group of **connected clients composed only of clients A and D**. The institution should document these assessments and their findings in a comprehensive way.



Control
Economic dependency

Annex

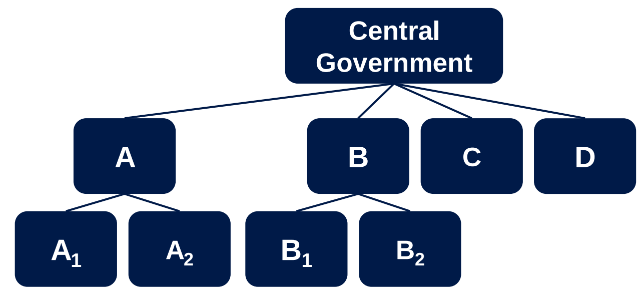
Alternative approach for exposures to central governments

Within the alternative approach for exposures to central governments there are several scenarios: general, CG 1 for partial use, CG 2 for all directly dependent entities…

Alternative approach for exposures to central governments (1/2)

General scenario

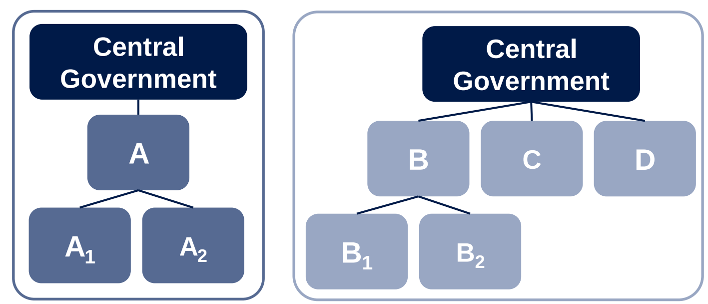
- The **central government directly controls four legal persons** (A, B, C and D). Entities A and B themselves have direct control over two subsidiaries each (A_1/A_2, B_1/B_2). The reporting institution has exposures to the central government and all of the entities shown.



Scenario CG 1

Alternative approach – partial use

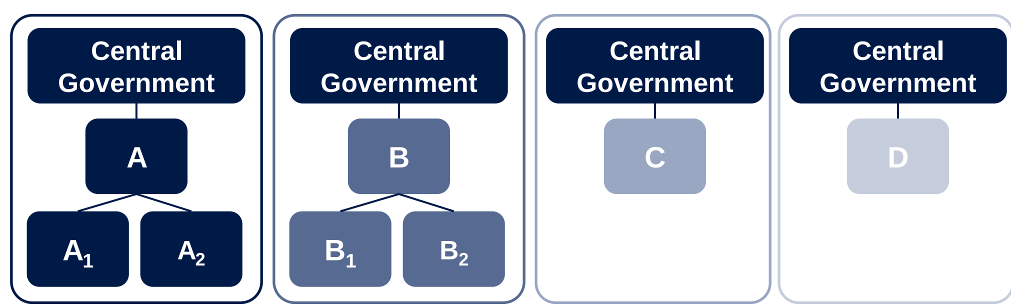
- The reporting institution could **carve out only one group** ('central government/A/all controlled or dependent entities of A') and **keep the general treatment for the rest** ('central government/B, C and D/all controlled or dependent entities of B').



Scenario CG 2

Alternative approach – used for all directly dependent entities

- The reporting institution could **carve out groups for all directly dependent entities** (A, B, C and D).



——— Control - - -> Economic dependency

Alternative approach for exposures to central governments

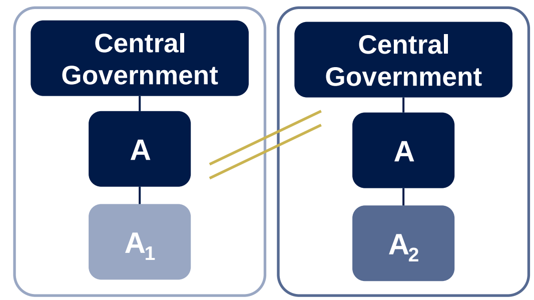
…CG 3 applicable on first/second level, and CG 4 for horizontal connections on the second level scenarios

Alternative approach for exposures to central governments (2/2)

Scenario CG 3

Alternative approach – applicable on 'first/second level', not below

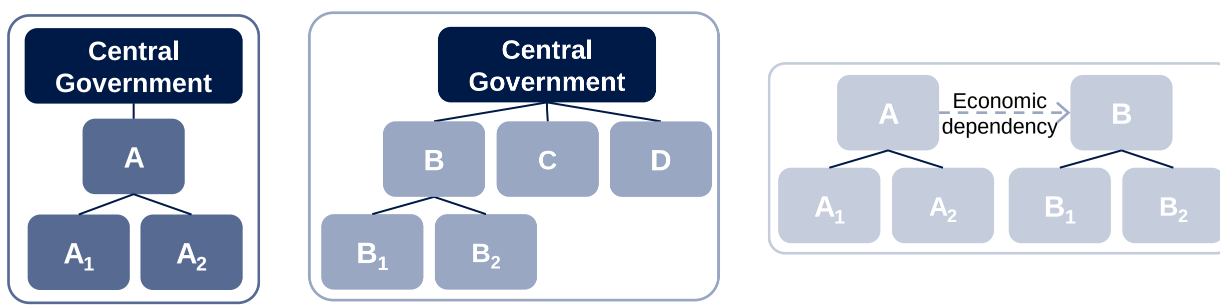
- In the scenarios CG 1 and CG 2, entities A, B, C and D constitute the 'second level', i.e. the level directly below the central government ('first level'). Here, a **carve-out from the overall group of connected clients is possible**. However, entities A_1, A_2, B_1 and B_2 are only indirectly connected to the central government. **A carve-out on their level is not possible** (e.g. both A_1 and A_2 need to be included in the group 'central government/A')



Scenario CG 4

'Horizontal connections' on the 'second level'

- In a variation on the general scenario above, entities A and B are economically dependent (payment difficulties for B would be contagious to A).
- Assuming that the reporting institution uses the alternative approach only in part, as described in scenario CG 1, the following **groups of connected clients need to be considered**:



Control
Economic dependency

Establishing interconnectedness based on economic dependency

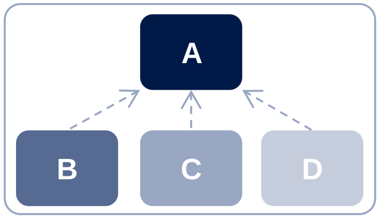
Regarding the interconnectedness based on economic dependency, there are several scenarios: E1 on a main case, E2 on the variation on main case where there is not direct exposure to source of risk, E3 on the case of overlapping groups of connected clients,…

Establishing interconnectedness based on economic dependency (1/3)

Scenario E1

Main case

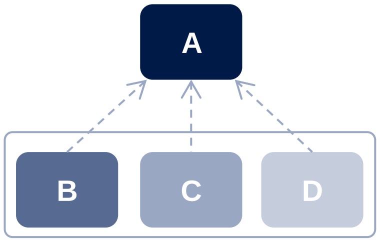
- The reporting institution has exposures to all entities shown below (A, B, C and D). B, C and D rely economically on A. Hence **the underlying risk factor for the institution is in all cases A**. The institution has to form one comprehensive group of connected clients, not three individual ones. It is irrelevant that there is no dependency among B, C and D.



Scenario E2

Variation on main case (no direct exposure to source of risk)

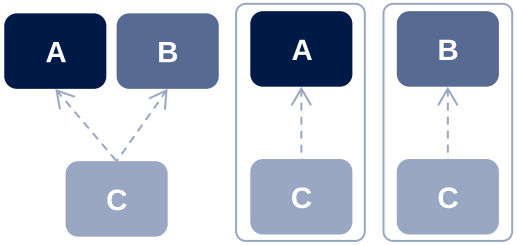
- There is a grouping requirement even if the reporting institution does not have a direct exposure to A but is aware of the economic dependency of each client (B, C and D) on A. If possible payment difficulties for A are contagious to **B, C and D**, they **will all experience payment difficulties if A gets into financial trouble**. Therefore, they need to be treated as a single risk.
- As in scenario E1, it does not matter that there is no dependency among B, C and D. A causes the grouping requirement, although it is not a client itself and thus is not part of the group of connected clients.



Scenario E3

Overlapping groups of connected clients

- If an entity is **economically dependent on two (or more) other entities** (note that the payment difficulties of one of the other entities (A or B) might be sufficient to result in C being in difficulty), it has to be **included in the groups of connected clients of both entities**.
- The argument that the exposure to C will be double-counted is not valid because the exposure to C is considered a single risk in two separate groups.
- The large exposure limit applies separately (i.e. the limit applies once to exposures to group A/C and once to exposures to group B/C).
- As there is no dependency between A and B, no comprehensive group (A + B + C) needs to be formed.



——— Control - - -> Economic dependency

Establishing interconnectedness based on economic dependency

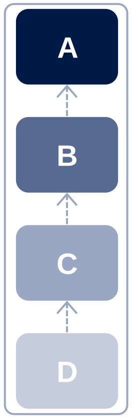
…E4 for chain of dependency, E5 where the reporting institution acts as a source of funding without grouping requirement,…

Establishing interconnectedness based on economic dependency (2/3)

Scenario E4

Chain of dependency

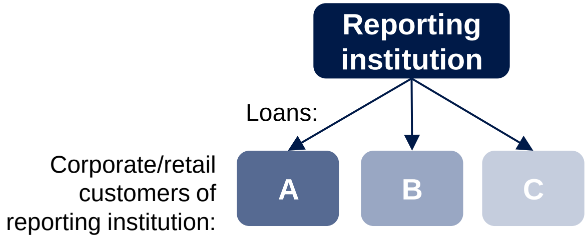
- In the case of a 'chain of dependency', **all entities that are economically dependent** (even if the dependency is only one way) **need to be treated as one single risk**. It would not be appropriate to form three individual groups (A + B, B + C, C + D).



Scenario E5

Reporting institution as source of funding (no grouping requirement)

- In this scenario the reporting institution is the sole provider of funds for three customers. It is not an 'external funding source' that connects the three clients and **it is a funding source that can normally be replaced**.



Control
Economic dependency

Annex

Establishing interconnectedness based on economic dependency

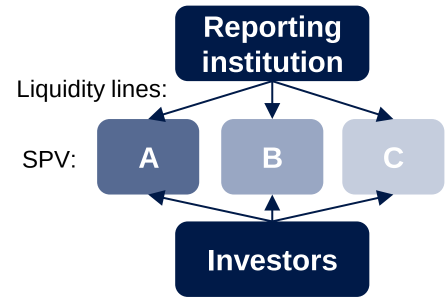
…and E6 where the reporting institution acts as a source of funding with grouping requirement

Establishing interconnectedness based on economic dependency (3/3)

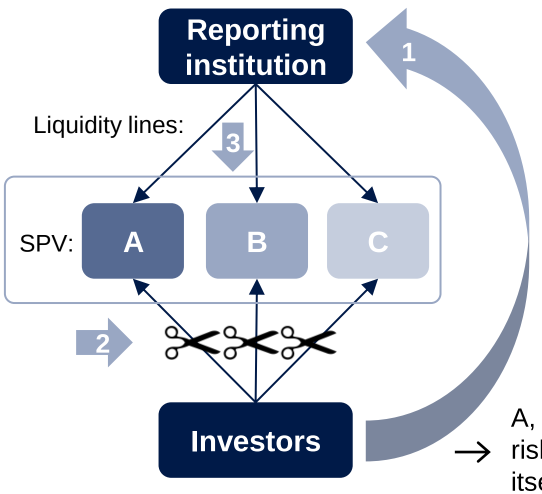
Scenario E 6

Reporting institution as source of funding (grouping requirement)

- In this scenario, the reporting institution is the **liquidity provider of three SPVs or conduits** (similar structures).



- In such a case, the reporting institution itself can constitute the **source of risk** (underlying risk factor).
- In this scenario, it does not make a difference whether the liquidity lines are directly to the SPV or to underlying assets within the SPV; what matters is the fact that liquidity lines are likely to be drawn on simultaneously. Diversification and quality of the assets are also not considerations in this scenario, nor is the reliance on investors in the same sector (e.g. investors in the ABCP market), as the single risk is created by the use of similar structures and the reliance on commitments from one source (i.e. the reporting institution as the originator and sponsor of the SPVs).



1. Negative assessment/ perception of investors of liquidity situation of reporting institution
2. Investors withdraw from SPV
3. Liquidity lines are simultaneously drawn

→ A, B, C constitute a single risk, the reporting institution itself is the linking factor

——— Control - - -> Economic dependency

Annex

Interconnectedness through control and economic dependency

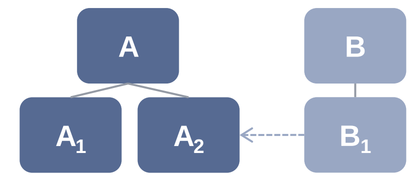
Regarding the relation between interconnectedness through control and interconnectedness through economic dependency there are several scenarios: C/E 1 for combined occurrence of control and one-way economic dependency, C/E 2 for two-way dependency,…

Interconnectedness through control and economic dependency (1/2)

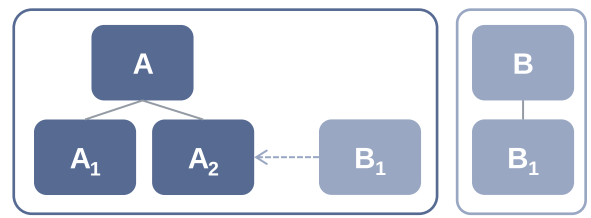
Scenario C/E 1

Combined occurrence of control and economic dependency (one-way dependency)

- In this scenario, **the reporting institution has exposures to all entities** shown in the diagram. A controls A_1 and A_2, B controls B_1. Furthermore, B_1 is economically dependent on A_2 (one-way dependency).



- **Grouping requirement**. In this scenario, the reporting institution should come to the conclusion that B_1 is in any case to be included in the group of connected clients of A (the group thus consisting of A, A_1, A_2 and B_1) as well as of B (the group thus consisting of B and B_1).

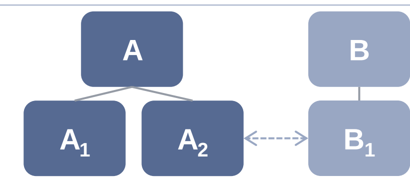


- In case of financial problems for A; A_2 and ultimately B_1 will also experience financial difficulties due to legal (A_2) and economic (B^1) dependency. The forming of three different groups ($A+A_1+A_2$; A_2+B_1; $B+B_1$) would not be sufficient to capture the risk stemming from A, because B_1 would be carved out of the single risk of group A.

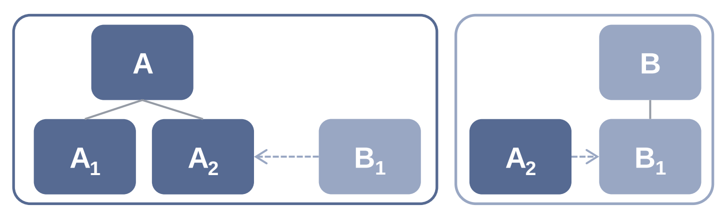
Scenario C/E 2

Combined occurrence of control and economic dependency (two-way dependency)

- In this scenario, the **economic dependency of A_2 and B_1 is not only one way but mutual**.



- **Grouping requirement**. A_2 would need to be included additionally in group B, and B_1 would need to be included additionally in group A.



——— Control - - -> Economic dependency

Interconnectedness through control and economic dependency

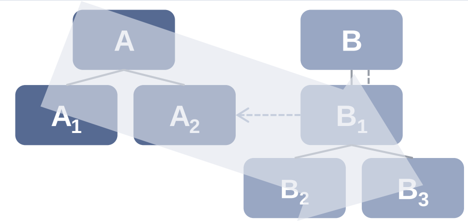
…C/E 3 for downstream contagion, and C/E 4 for upstream contagion

Interconnectedness through control and economic dependency (2/2)

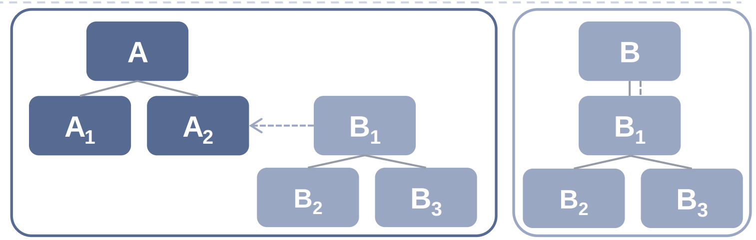
Scenario C/E 3

Downstream contagion

- In a variation on scenario C/E 1, B_1 also controls two entities (B_2 and B_3). In this case, the **financial difficulties of A will pass through A_2 and B_1 down to the two subsidiaries of B_1** (downstream contagion).



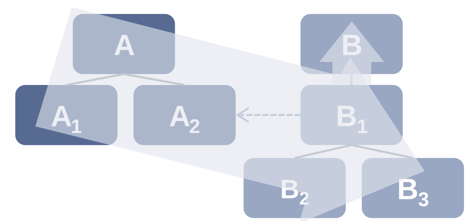
- **Grouping requirement**. In this scenario, the reporting institution should come to the conclusion that B_1 (and thus B_2 and B_3) is in any case to be included in the group of connected clients of A (the group consisting of A, A_1, A_2, B_1, B_2 and B_3). There will be another group including B, B_1, B_2 and B_3.

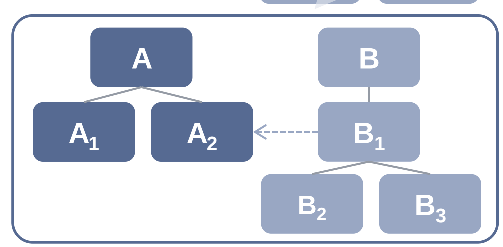


Scenario C/E 4

Upstream contagion

- The control relationship between B and B_1 does not automatically lead to including B in the group of A, as financial problems for A are not likely to result in financial difficulties for B. However, the controlling entity B needs to be included in the group of A if B_1 forms such an important part of group B that B is economically dependent on B_1. In this case, **the financial difficulties of A will proceed also upwards to B** (upstream contagion).
- **Grouping requirement**. The reporting institution should form a group of connected clients with A, A_1, A_2, B, B_1, B_2 and B_3.





Control - - -> Economic dependency

Control and management procedures for identifying connected clients

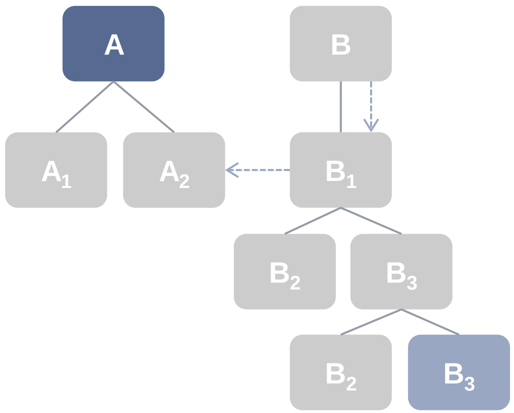
Finally, regarding the control and management procedures there is a scenario Mm1 for the limits to the identification of a chain of contagion

Control and management procedures for identifying connected clients

Scenario Mm1

Limits to the identification of a chain of contagion

- Further developing the scenario C/E4, the reporting institution has exposures only to entity A and entity B_3.
- In such a case, it is recognised that it might **not be possible** for the reporting institution **to become aware of the chain of contagion** and the group of connected clients might not be correctly formed.



Control
Economic dependency