

EBA/CP/2016/09

---

26 July 2016

---

# Consultation Paper

---

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

---

# Contents

---

<b>1. Responding to this consultation</b>	<b>3</b>
<b>2. Executive Summary</b>	<b>4</b>
<b>3. Background and rationale</b>	<b>6</b>
<b>4. Draft Guidelines</b>	<b>25</b>
<b>5. Accompanying documents</b>	<b>39</b>

# 1. Responding to this consultation

---

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

## Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 26.10.2016. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

## Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

## Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

## 2. Executive Summary

---

The 'Guidelines on the implementation of the revised large exposures regime' issued by the Committee of European Banking Supervisors (CEBS) on 11 December 2009 aimed at ensuring the harmonised implementation of that regime across Member States. However, since then, the large exposures regime has been amended by Regulation (EU) No 575/2013 ('CRR') and complemented by the European Commission's regulations and the European Banking Authority's (EBA) guidelines. To ensure consistency with those regulations and guidelines and avoid overlaps, the EBA has reviewed and updated the 2009 CEBS Guidelines and presents the result of that review in this consultation paper.

The revised guidelines focus exclusively on the issue of connected clients as defined in Article 4(1)(39) of the CRR and take into account developments in the area of shadow banking and large exposures at Union and international level. The guidelines cover the two types of interconnection considered in the definition of connected clients of the CRR, i.e. control relationships and economic dependencies, which lead to the formation of groups of connected clients.

Regarding the assessment of connections based on control, the guidelines clarify that institutions should make use of their clients' consolidated financial statements. For clients to which the EU accounting rules do not apply (e.g. natural persons, central governments, and clients which prepare consolidated financial statements in accordance with the accounting rules of a third country), the guidelines provide a non-exhaustive list of indicators of control that should be used by institutions. This list of control indicators (e.g. holding the majority of the shareholders' or members' voting rights in another entity; or right or ability to appoint or remove a majority of the members of the administrative, management or supervisory body of another entity; etc) was developed on the basis of accounting indicators, the list included in the 2009 CEBS Guidelines and informal feedback from institutions regarding their current practices.

In addition, the guidelines clarify the concept of 'single risk' i.e. two or more clients are so interconnected that if one of them experiences financial difficulties, the other(s) would also be likely to encounter funding or repayment difficulties. 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. The understanding that only in exceptional cases the existence of a control relationship does not lead to a 'single risk' constitutes a more prudent approach when compared to the 2009 CEBS Guidelines.

The guidelines also provide guidance regarding the use of an alternative approach, introduced by the last sub-paragraph of Article 4(1)(39) of the CRR, for the assessment of the existence of groups of connected clients of entities directly controlled by or directly interconnected with central governments (or regional or local governments to which Article 115(2) of that Regulation applies).

Regarding the assessment of economic dependency, the guidelines develop the non-exhaustive list of situations of economic dependency that was included in the 2009 CEBS Guidelines. The present guidelines reinforce, however, this definition to make clear that if the failure of a client would lead to *'repayment difficulties'* of another client an institution is to regard these clients as a group of connected clients. The guidance regarding common sources of funding is in substance the same as in the 2009 CEBS Guidelines and requires that institutions consider situations where funding problems of one client are likely to spread to another due to a one-way or two-way dependency on the same funding source, e.g. use of one funding entity that cannot be easily replaced; reliance on commitments from one source (such as guarantees, credit support in structured transactions or non-committed liquidity facilities) and its solvency; etc.

The guidelines also clarify 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. The overarching indicator is the existence of a 'single risk' between two or more clients ('domino effect'), regardless of the type of connection the single risk is based upon. The chain of contagion leading to possible default of all entities concerned is the relevant factor for the grouping.

The final section of the guidelines is broadly similar to the 2009 CEBS Guidelines and sets out the control and management procedures to identify connected clients. It is in the interest of an institution to identify all possible connections among its clients to have a clear understanding of the risks it is exposed to. However, the guidelines acknowledge the inherent difficulties of identifying economic connections and recommend that an institution increases its efforts to identify (and document as appropriate) such economic connections for all exposures that reach an exposure value equal to or above 2% of its eligible capital.

The present guidelines are consistent with the Standards on the 'Supervisory framework for measuring and controlling large exposures' issued by the Basel Committee on Banking Supervision in April 2014. They are, nevertheless, more detailed and also include aspects which are not considered in the Basel Standards (e.g. alternative approach for exposures to central governments, relation between interconnectedness through control and economic dependency). In addition, the Basel Standards recommend that banks identify economic dependencies in all cases where the sum of all exposures to one individual counterparty exceeds 5% of Tier 1 capital (opposed to the minimum threshold of 2% of eligible capital proposed in the guidelines).

## 3. Background and rationale

---

### 3.1 General background

#### 3.1.1 Legal framework and relation to other parts of the EU rulebook

1. The large exposures regime contained in the previous Capital Requirements Directive<sup>1</sup> was complemented by guidelines issued by the Committee of European Banking Supervisors (CEBS) on 11 December 2009. These guidelines aimed at ensuring a harmonised implementation of the revised large exposures regime across the Member States ('2009 CEBS Guidelines').<sup>2</sup>
2. Regulation (EU) No 575/2013<sup>3</sup> has partially revised the large exposures regime as provided for in the previous Capital Requirements Directive. This Regulation, while recognising some discretions regarding exemptions to be exercised by competent authorities (Article 400(2)) or Member States (Article 493(3)), sets out a large exposures framework directly applicable in all Member States. To fulfil the mandates included in that Regulation in the area of large exposures, the EBA has developed the following technical standards and guidelines:
  - i) Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets;<sup>4</sup>
  - ii) Implementing Technical Standards on supervisory reporting, also covering reporting of large exposures;<sup>5</sup> and
  - iii) Guidelines on limits to exposures to shadow banking entities which carry out banking activities outside a regulated framework.<sup>6</sup>
3. The new provisions established in Regulation (EU) No 575/2013 together with the EBA technical standards and guidelines in the area of large exposures, lead to inconsistencies in certain areas of the 2009 CEBS Guidelines with some overlapping in other areas of those guidelines.

---

<sup>1</sup> Directive 2006/48/EC and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 as amended by Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009.

<sup>2</sup> The CEBS 'Guidelines on the implementation of the revised large exposures regime' cover two aspects: the definition of connected clients and the treatment of transactions with exposures to underlying assets. The guidelines can be found here: [https://www.eba.europa.eu/documents/10180/37070/Guidelines-on-Large-exposures\\_connected-clients-and-schemes.pdf](https://www.eba.europa.eu/documents/10180/37070/Guidelines-on-Large-exposures_connected-clients-and-schemes.pdf)

<sup>3</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 321, 30.11.2013, p. 6).

<sup>4</sup> Published as in the EU Official Journal as Regulation of the European Commission n. 1184/2014 (this Regulation replaced Part II of the 2009 CEBS Guidelines on treatment of transactions with exposures to underlying assets): [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.324.01.0001.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.324.01.0001.01.ENG).

<sup>5</sup> Published as in the EU Official Journal as the European Commission's Implementing Regulation (EU) No 680/2014 on supervisory reporting (and subsequent amendments), which replaced the 2009 CEBS Guidelines on common reporting of large exposures: <https://www.eba.europa.eu/regulation-and-policy/supervisory-reporting/implementing-technical-standard-on-supervisory-reporting>

<sup>6</sup> These guidelines have been published in December 2015: <https://www.eba.europa.eu/regulation-and-policy/large-exposures/guidelines-on-limits-on-exposures-to-shadow-banking>

4. In light of the above, the EBA has decided to review the 2009 CEBS 'Guidelines on the implementation of the revised large exposures regime', focusing exclusively on the issue of connected clients under Article 4(1)(39) of Regulation (EU) No 575/2013. Additionally, the current guidelines take into account the outcomes of developments in the area of shadow banking and large exposures at Union and international level.
5. Regulation (EU) No 575/2013 has confirmed that the large exposures rules constitute a backstop regime designed to limit the impact of a client's failure on an institution. The objective of the definition of 'connected clients' in that Regulation is to identify counterparties so closely linked by idiosyncratic risk factors that it is prudent to treat them as a single risk. Idiosyncratic risk represents the effect of risks that are specific to individual counterparties. Idiosyncratic risk arises where, in a bilateral interrelationship, financial problems of one entity are transferred via this interrelationship to another entity which otherwise would not be concerned. Consequently, the purpose of these guidelines is to clarify and operationalise the concept of interconnection, in particular when control issues or economic dependency should lead to the grouping of clients because they constitute a single risk in accordance with Article 4(1)(39) of Regulation (EU) No 575/2013.
6. These guidelines cover both types of interconnection considered in the definition of connected clients in Article 4(1)(39) of Regulation (EU) No 575/2013:
  - i) the clients are directly or indirectly interconnected by a control relationship as defined in Article 4(1)(37) of the same Regulation;
  - ii) the clients are interconnected by some form of economic dependency as set out in Article 4(1)(39)(b), as for instance:
    - direct economic dependencies such as supply chain links or dependence on large customers, or
    - the clients have a main common source of funding in the form of credit support, potential funding or direct, indirect or reciprocal financial assistance.
7. 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. Geographical and sectoral risks can be described as a dependency linked to an external factor (such as, for example, a certain product market or a specific region) which affects all entities active in the sector or region in the same manner. Institutions that only operate in a well-defined geographic area, or in an area dominated by one specific industry (sector), are not more affected in their conduct of business by the connected clients' rule than other institutions.
8. The concept of connected clients is applied in two different contexts in Regulation (EU) No 575/2013. Apart from large exposures, it is also applied when categorising clients in the retail exposure class for the purposes of credit risk (Article 123 of that Regulation). However, in these guidelines, the EBA focuses on the application of Article 4(1)(39) in relation to Part Four of that Regulation (large exposures regime) only.

## 3.2 Rationale for the proposals and main changes from the CEBS ‘Guidelines on the implementation of the revised large exposures regime’

### 3.2.1 Control

9. The definition of ‘control’ in Article 4(1)(37) of Regulation (EU) No 575/2013 points to the accounting definition of the relationship between a parent undertaking and a subsidiary, as defined in the new Accounting Directive 2013/34/EU<sup>7</sup> or the accounting standards to which an institution is subject under Regulation (EC) No 1606/2002<sup>8</sup>, or a similar relationship between any natural or legal person and an undertaking. Therefore, where the new Accounting Directive 2013/34/EU is applicable, such Directive has an impact on the way institutions assess control relationships for the purposes of grouping connected clients in the context of the large exposures regime.
10. Article 22(1), (2), and (7) of Directive 2013/34/EU contain several options and national discretions for Member States as regards the transposition of such provisions, therefore leaving the definition of ‘group’ for the purposes of consolidation of accounts, to the Member States. Consequently, the definition of ‘control’ for the purpose of forming groups of connected clients in the context of the large exposures regime will also depend on the national transposition of these options and national discretions. The present guidelines regarding the ‘control’ criterion respect the national transposition of Directive 2013/34/EU, which may potentially lead to different grouping requirements depending on where institutions’ clients are required to prepare their consolidated financial statements.
11. These guidelines clarify that institutions should make use of their clients’ consolidated financial statements<sup>9</sup> when assessing connections based on control. For clients to which the EU accounting rules do not apply (e.g. natural persons, central governments, and clients which prepare consolidated accounts in accordance with the accounting rules of a third country), the guidelines provide a non-exhaustive list of indicators of control that should be used by institutions when assessing control relationships among clients which fall in this category. This list of control indicators was developed on the basis of accounting indicators<sup>10</sup>, the list included in the 2009 CEBS Guidelines and informal feedback from institutions regarding their current practices<sup>11</sup>. The feedback from institutions showed a high degree of harmonisation of practices and, as expected, a heavy reliance on accounting indicators as well as the 2009 CEBS Guidelines.

<sup>7</sup> Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.

<sup>8</sup> Regulation (EC) No 1606/2002 the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

<sup>9</sup> Prepared in accordance with Directive 2013/34/EU or Regulation (EC) 1606/2002.

<sup>10</sup> Found in Directive 2013/34/EU and Regulation (EC) 1606/2002.

<sup>11</sup> A sample of institutions from AT, BE, DE, ES, FR, IE, IT, LU, PL, PT, SI and the UK shared their current practices regarding the creation of groups of connected clients on the basis of ‘control’.



12. In addition, the guidelines clarify the concept of ‘single risk’ (i.e. two or more clients are so interconnected that if one of them experiences financial difficulties, the other(s) would also be likely to encounter funding or repayment difficulties); and also that the burden of proof is on the institution to demonstrate that despite the existence of a control relationship among the clients, those clients, by way of *exception*, do not constitute a ‘single risk’. The understanding that only in *exceptional* cases the existence of a control relationship does not lead to a ‘single risk’ is deemed more prudent than the 2009 CEBS Guidelines which did not emphasise this as an *exception* to the rule of connecting clients due to control relationships. The reasoning of the current guidelines is where a control relationship exists; the controlling person/entity has legally enforceable rights that establish a strong form of financial dependency on the controlling person/entity by the controlled entity. In case of financial problems of the controlling person/entity, it is highly likely that the controlling person/entity could make use of its rights to extract capital and/or liquidity from the controlled entity thereby weakening the financial position of the latter. Financial problems could be transferred to the controlled entity with the result that both the controlling person/entity and the controlled entity would experience financial problems (‘domino effect’). From the perspective of prudential risk stemming from large exposures it is therefore appropriate to attach the strong assumption of a single risk to a relationship of control between different clients.

13. Finally it is to be noted that the assessment of control relationships is only the first step in the assessment of the connection among clients, before assessing any potential economic dependency.

### 3.2.2 Alternative approach for exposures to central governments<sup>12</sup>

14. The principles and criteria for forming a group of connected clients are the same, irrespective of whether the head of the group is a central government or not. Therefore, in general, institutions have to assess the existence of a group of connected clients for the central government itself and treat the whole set consisting of the central government and all of the natural or legal persons directly or indirectly controlled by it in accordance with point (a) of Article 4(1)(39) of Regulation (EU) No 575/2013 or interconnected with it in accordance with point (b) of that same Article as one single group of connected clients.

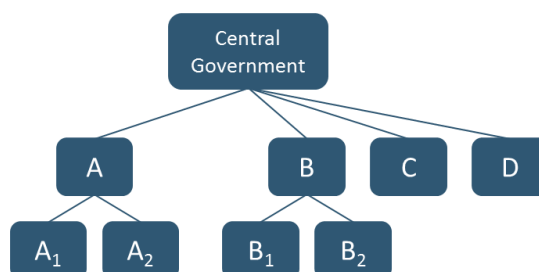
15. However, the last sub-paragraph of Article 4(1)(39) of Regulation (EU) No 575/2013 permits institutions to make use of a different approach in assessing the existence of a group of connected clients separately for each of the persons directly controlled by or directly interconnected with the central government (‘alternative approach’). The term ‘may’ makes it clear that using this alternative approach is not mandatory but left to institutions’ discretion. This is a new discretion introduced by Regulation (EU) No 575/2013; therefore the guidance provided in the 2009 CEBS Guidelines needs to be fully revised.

---

<sup>12</sup> The same approach applies in cases of regional governments or local authorities to which Article 115(2) of Regulation (EU) No 575/2013 applies.

16. These guidelines clarify that usually entities like government departments, ministries and other governmental authorities, which are not separate legal entities and do not take up loans in their own name, but which altogether constitute the central government should be regarded as one single entity, i.e. the central government. Thus, these entities are not eligible for separately assessing the existence of a group of connected clients.<sup>13</sup>

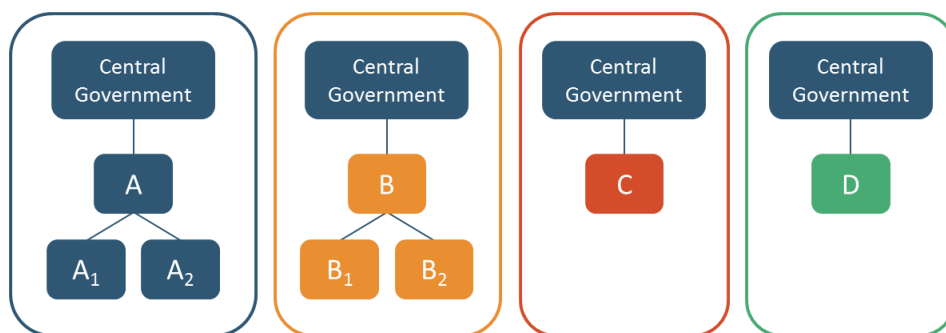
**For illustration purposes, the following general example is used:** The central government directly controls four legal persons (A, B, C and D). Entities A and B themselves have direct control over two subsidiaries each (A<sub>1</sub>/A<sub>2</sub>, B<sub>1</sub>/B<sub>2</sub>). The reporting institution has exposures to the central government and all of the depicted entities.



17. Where a central government has direct control over or is directly interconnected with more than one natural or legal person, the specification ‘including the central government’ for the alternative approach should be understood as requiring to always **include the central government 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.

<sup>13</sup> Refer to [Q&A 2013 681](#).

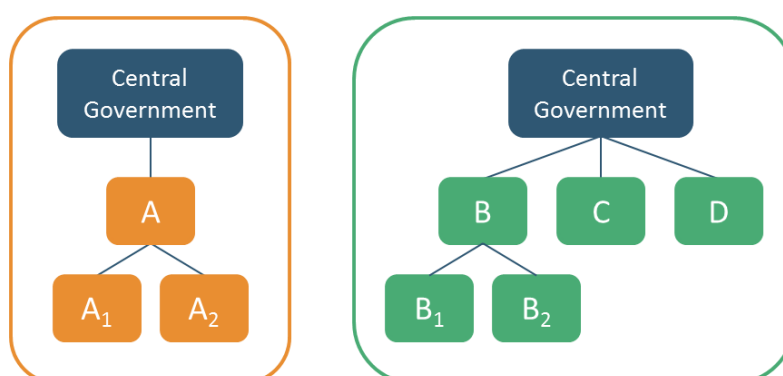
**Example CG 1:** Alternative Approach – used for all directly dependent entities



18. Additionally, institutions may also **partially apply the alternative approach**, i.e. only for some of the natural or legal persons directly controlled by or directly interconnected with the central government.

**Example CG 2:** Alternative Approach – partial use

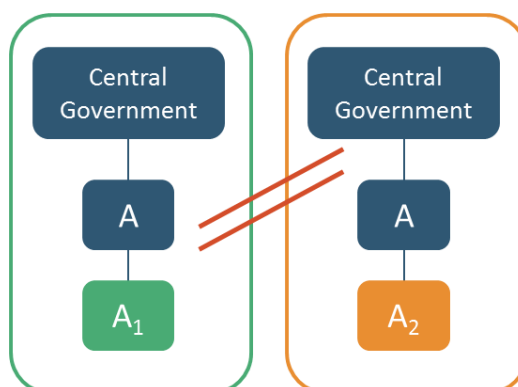
The reporting institution could carve out only one group ('central government/A/all controlled or dependent entities of A') and keep the general treatment for the rest ('central government/B, C and D/all controlled or dependent entities of B'):



19. The alternative approach permits a separate assessment only for 'natural or legal persons' **directly controlled by or directly interconnected** with the central government. Furthermore, this alternative approach is not possible for further sub-structures, i.e. for natural or legal persons solely indirectly controlled by or indirectly interconnected with the central government. Instead, such entities are to be included in the respective group of connected clients for the entity directly controlled by or directly interconnected with the central government.

**Example CG 3:** Alternative approach – applicable on ‘first/second level’, not below

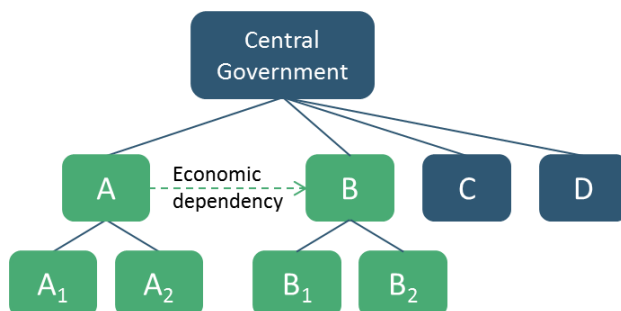
In the examples CG 1 and CG2, entities A, B, C and D constitute ‘the second level’, i.e. the level directly below the central government (‘first level’). Here, the carve-out from the overall group of connected clients is possible. However, entities A<sub>1</sub>, A<sub>2</sub>, B<sub>1</sub> and B<sub>2</sub> are only indirectly connected to the central government. A carve-out on their level is not possible (for example, both A<sub>1</sub> and A<sub>2</sub> need to be included in the group ‘central government/A’):



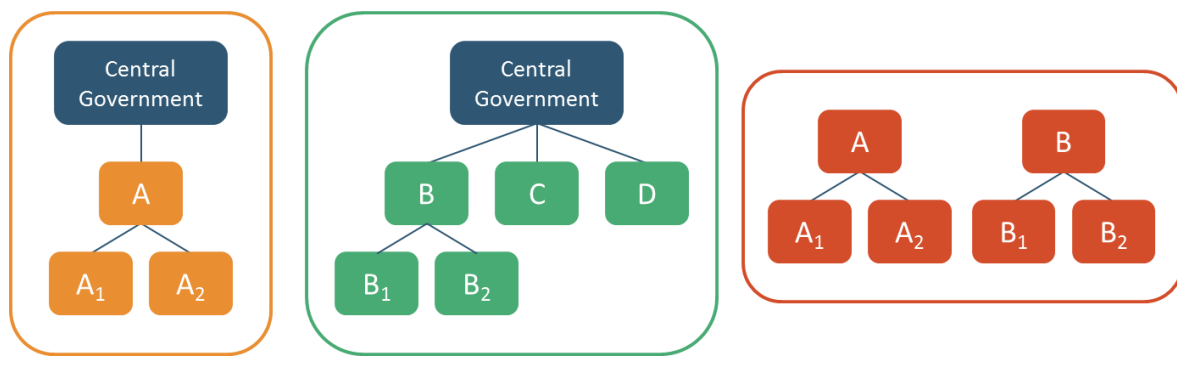
20. Nonetheless, applying the alternative approach for exposures to central governments and entities directly controlled by or interconnected with them does not allow disregarding connections on the level below the central government. Economic dependencies among such entities need to be reflected in separate groups of connected clients (not including the central government). The alternative approach only looks at the relationship between the central government and entities directly connected to it. Idiosyncratic risk that might arise in the relationship *among* such entities needs to be assessed separately.

**Example CG 4: ‘Horizontal connections’ on the ‘second level’**

In variation to the general example above, entities A and B are economically dependent (payment difficulties of B would be contagious to A):



Assuming that the institution uses the alternative approach partially as described in example CG 2 above, the following groups of connected clients need to be considered:



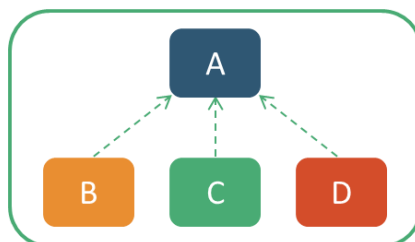
21. Section 5 of the guidelines also applies to regional governments or local authorities to which Article 115 (2) of Regulation (EU) No 575/2013 applies.

**3.2.3 Establishing connectedness based on economic dependency**

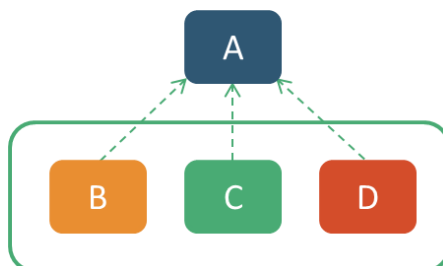
22. Even if the issue of control of one client over another does not apply, institutions are obliged to assess whether there exists a relationship of economic dependency among clients. If it is likely that the financial problems of one client would cause difficulties for the other(s) in terms of full and timely repayment of liabilities, there exists an idiosyncratic risk that needs to be addressed by considering the clients as connected. An economic dependency among clients may be mutual or only one way.

**Example E1:** Main case

The reporting institution has exposures to all entities shown below (A, B, C and D). B, C and D rely economically upon 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.

**Example E2:** Variation to main case (no direct exposure to source of risk)

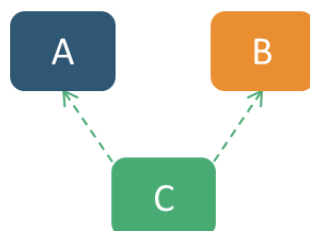
There is a grouping requirement even if the reporting institution does not have a direct exposure to A but is aware of economic dependency of each client (B, C and D) upon A. If possible payment difficulties of A are contagious to B, C and D, they all will experience payment difficulties once A gets into financial troubles. Thus, they need to be treated as a single risk.



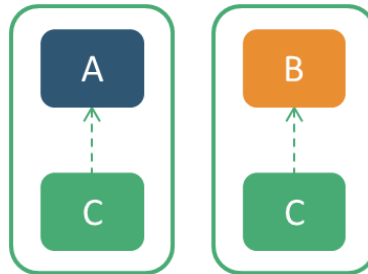
Like in example E 1 it does not matter that there is no dependency among B, C and D. A causes the grouping requirement, although it is not a client itself and thus is not part of the group of connected clients.

**Example 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 for C being in difficulty)...



... it has to be included in the groups of connected clients of both (all such) entities:

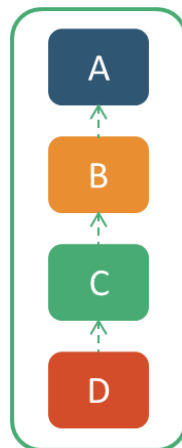


The argument of double counting the exposure to C is not valid because the exposure to C is considered a single risk in two separate groups to which the large exposure limit applies separately (i.e. the limit applies once against exposures to group A/C and once against exposures to group B/C).

As there is no dependency between A and B no comprehensive group (A+B+C) needs to be formed.

**Example E 4:** 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).



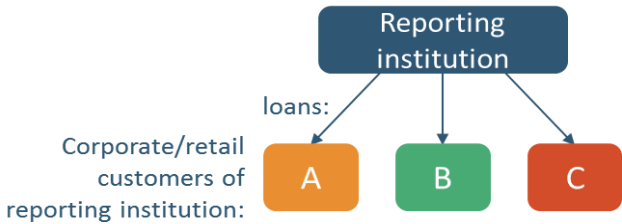
23. According to paragraph 42 of the 2009 CEBS Guidelines there was no requirement to consider clients to be interconnected as long as an institution concluded that the failure of a client would not lead to ‘substantial, existence-threatening repayment difficulties’ of another client. These guidelines propose to delete the expression ‘substantial, existence-threatening’ and keep only ‘repayment difficulties’ in order to accurately reflect the definition of ‘group of connected clients’ stated in Article 4(1)(39) of Regulation (EU) No 575/2013.

24. Dependency might arise in the context of business interconnections (such as supply chain links, dependence on large customers or counterparty exposures, financial dependency) which are not linked to respective sectoral or geographical risks, and suggests that the clients involved are exposed to the same idiosyncratic risk factor. If this idiosyncratic risk materializes, one or both obligors are likely to experience repayment difficulties. Consequently, interconnections among entities (or persons) due to bilateral business relationships may lead to contagion risk which is independent from sectoral or geographical risks. The fact that the existence of common idiosyncratic risk factors may lead to contagion risk for otherwise independent clients, is the core of the concept of economic interconnection.
25. The rationale for the definition of economic interconnection in Article 4(1)(39)(b) is to identify channels of contagion stemming from economic dependencies that a client cannot overcome without experiencing repayment difficulties. However, even if a client is dependent on another client through, for instance, a business relationship, it could still be possible for the client to find a replacement for this business partner (in case of his default), or to compensate for such a loss by other means, for example, through reduction of costs, concentration on other sectors, etc. This may cause practical problems, such as lower margins but if an institution comes to the conclusion that it would not lead to repayment difficulties, there is no requirement to consider such clients to be interconnected. If an institution comes to the conclusion that the failure of a certain client would lead to repayment difficulties for another client, then these clients need to be considered interconnected.
26. The guidance regarding common sources of funding is in substance the same as in the 2009 CEBS Guidelines. It should be noted that a common source of funding due solely to geographical location does not, in itself, lead to a requirement to connect clients under the large exposures regime. Small and medium sized entities will, in many cases, not have the capacity or commercial incentive to use institutions other than their local bank, and in addition, for most of them the personal relationship with their banker is the key to better financial services. This fact does not in itself justify these clients to be regarded as interconnected, even though they have a common source of funding (i.e. the reporting institution itself). Such funding dependencies differ from funding dependencies described in these guidelines because the common source of funding is due to the geographical location and can normally be replaced.



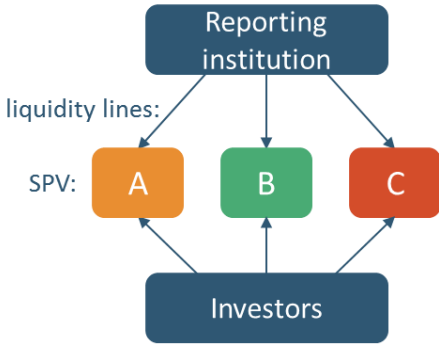
**Example E 5:** Reporting institution as source of funding (no grouping requirement)

In the following example 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 is a funding source that can normally be replaced.

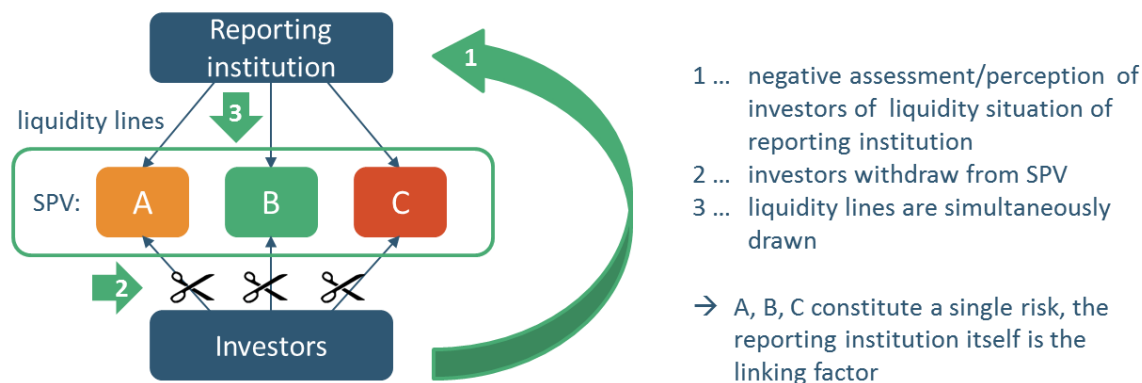


**Example E 6:** Reporting institution as source of funding (grouping requirement)

In the following example the reporting institution is the liquidity provider of three special purpose vehicles or conduits (similar structures):



In such a case, the reporting institution itself can constitute the source of risk (the underlying risk factor) as recognised in recital 54 of Regulation (EU) No 575/2013<sup>14</sup>:



In the example above, it does not make a difference if the liquidity lines are directly to the SPV or to underlying assets within the SPV; what matter is the fact that liquidity lines are likely to be drawn on simultaneously. Diversification and quality of the assets are also not a consideration in this example, nor the reliance on investors in the same sector (e.g. investors in 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 SPV).

27. Clients that depend on their existing source of funding simply because they are not creditworthy do not belong in this category. In the same way, being clients of the same institution does not in itself create a requirement to group the clients if the institution providing funding can be easily replaced. It is not required that an institution should collect information about whether its clients share an external common source of funding, however, institutions shall take into account accessible information in this regard.

28. Although these guidelines apply to exposures to shadow banking entities<sup>15</sup> in the same way they apply to exposures to other clients, the institution should pay particular attention when assessing connections among shadow banking entities. The EBA *'Guidelines on limits on exposures to shadow banking entities'* define prudential expectations regarding groups of shadow banking entities. In this context, institutions should give due consideration to the fact that elements of control among these shadow banking entities will most likely not consist of equity ties but rather of a different type of relationship, i.e. situations of *de facto* control or identifiable by contractual

<sup>14</sup> Recital 54 of Regulation (EU) No 575/2013 reads: 'In determining the existence of a group of connected clients and thus exposures constituting a single risk, it is also important to take into account risks arising from a common source of significant funding provided by the institution itself, its financial group or its connected parties.'

<sup>15</sup> As defined in the EBA guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No 575/2013: <https://www.eba.europa.eu/regulation-and-policy/large-exposures/guidelines-on-limits-on-exposures-to-shadow-banking>

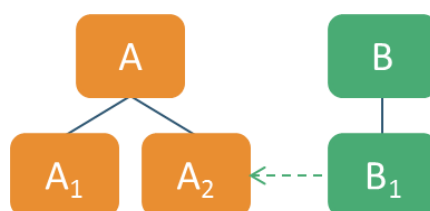
obligations, implicit support, or potential reputational risk (such as sponsorship or even branding)<sup>16</sup>.

### 3.2.4 Relation between interconnectedness through control and interconnectedness through economic dependency

29. The concepts of control and economic dependency are two different kinds of interconnection to be assessed separately. However, there are situations where both types of dependencies are interlinked and therefore could exist within one group of connected clients so that all relevant clients constitute a single risk. The wording in point (b) of Article 4(1)(39) of Regulation (EU) No 575/2013, 'between whom there is no relationship of control', does not lead to two mutually exclusive grouping requirements. It rather should be understood that the control relationship is a grouping requirement due to a very strong form of dependency (control as legal dependency) and thus is a subcategory of the wider form of economic dependency. The overarching indicator is the same in both cases, i.e. the single risk between two or more clients ('domino effect'), regardless of the type of connection the single risk is based upon. The chain of contagion leading to possible default of all entities concerned is the relevant factor for the grouping.

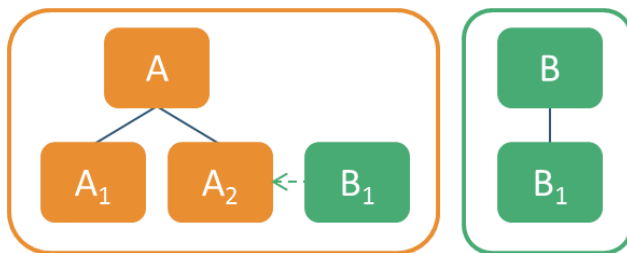
**Example C/E 1:** Combined occurrence of control and economic dependency (one-way dependency)

In the following example, the reporting institution has exposures to all entities shown in the diagram below. A controls A<sub>1</sub> and A<sub>2</sub>, B controls B<sub>1</sub>. Furthermore, B<sub>1</sub> is economically dependent on A<sub>2</sub> (one-way dependency):



**Grouping requirement:** In this example the reporting institution should come to the result that B<sub>1</sub> is in any case to be included in the group of connected clients of A (the group thus consisting of A, A<sub>1</sub>, A<sub>2</sub> and B<sub>1</sub>) as well as of B (the group thus consisting of B and B<sub>1</sub>):

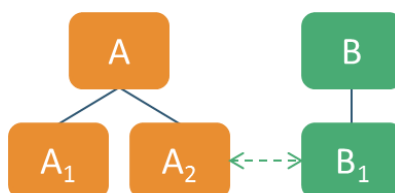
<sup>16</sup> In December 2015 the BCBS published a consultative document on "Identification and measurement of step-in risk" which proposes a conceptual framework that could form the basis of an approach for identifying, assessing and addressing step-in risk potentially embedded in banks' relationships with shadow banking entities mainly. It focuses on the identification of unconsolidated entities to which a bank may nevertheless provide financial support, in order to protect itself from any adverse reputational risk stemming from its connection to these entities.



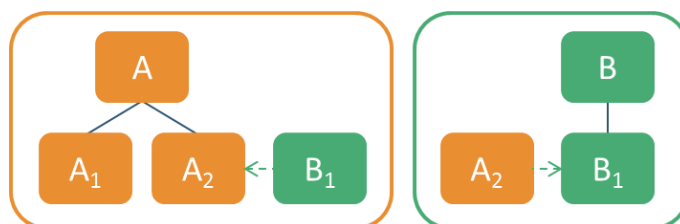
In case of financial problems of A also A<sub>2</sub> and ultimately also B<sub>1</sub> will experience financial difficulties due to their legal (A<sub>2</sub>) or economic (B<sub>1</sub>) dependency respectively. Mind, the forming of three different groups (A+A<sub>1</sub>+A<sub>2</sub>, A<sub>2</sub>+B<sub>1</sub>, B+B<sub>1</sub>) would not sufficiently capture the risk stemming from A because B<sub>1</sub>, although dependent on A<sub>2</sub> and thus on A itself, would be carved out of the single risk of group A.

**Example C/E 2:** Combined occurrence of control and economic dependency (two-way dependency)

If the economic dependency of A<sub>2</sub> and B<sub>1</sub> in the example above is not only one way but mutual:



Grouping requirement: A<sub>2</sub> would need to be included additionally in group B, and B<sub>1</sub> would need to be included additionally in group A



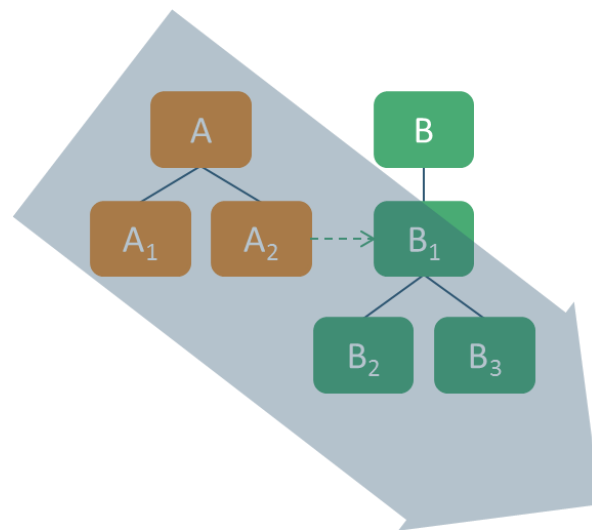
30. The overarching principle of all possible examples of groups of connected clients is that the possible contagion risk (“domino effect”) needs to be assessed in each individual case. Downstream contagion should be assumed when an entity is economically dependent on another client and is itself the head of a ‘control group’, i.e. a group of connected clients formed due to the existence of a control relationship in accordance with Article 4(1)(39)(a) of Regulation (EU) No 575/2013. If the other client is part of a group of connected clients the control group of the economically dependent entity should then be included in the group of connected clients to which the economic dependency relationship exists. The reason for this is that to overcome its own pending payment difficulties the economically dependent entity will most likely withdraw

resources from controlled entities, thus extending the risk of contagion ‘downstream’. Upstream contagion of entities that control the economically dependent entity, on the other hand, should only be assumed if this controlling entity is also economically dependent on the entity that constitutes the economic link between the two controlling groups.

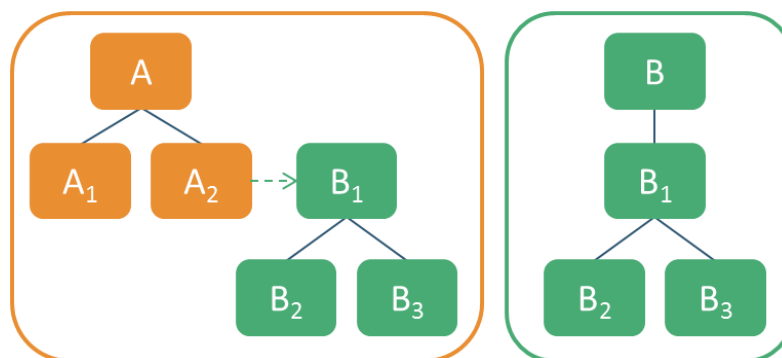
31. The 2009 CEBS Guidelines did not explicitly state that interconnections between control groups and economically dependent entities need to be established when there is a downstream chain of contagion. This has led to different interpretations and particularly the misconception that the non-grouping of controlled and economically dependent entities was the rule and grouping the exception.

**Example C/E 3: Downstream contagion**

In variation to the example above, also B<sub>1</sub> does control two entities (B<sub>2</sub> and B<sub>3</sub>). In this case, financial difficulties of A will pass through to A<sub>2</sub> and B<sub>1</sub> down to the two subsidiaries of B<sub>1</sub> (“downstream contagion”).



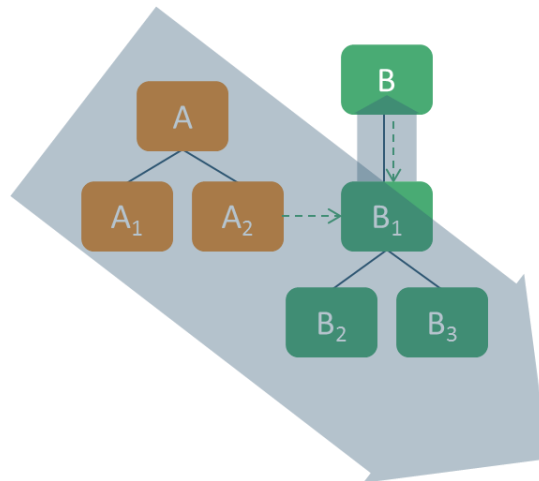
Grouping requirement:



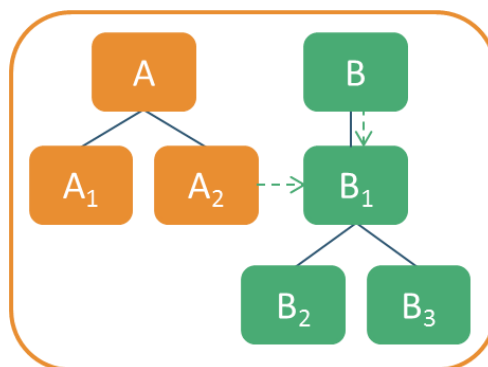
32. On the other hand, **upstream contagion** of entities that control the economically dependent entity should only be assumed when the controlling entity is also economically dependent on the entity that constitutes the economic link between the two controlling groups.

**Example C/E 2: Upstream contagion**

The control relationship between B and B<sub>1</sub> does not automatically lead to including also B into the group of connected clients of A as financial problems of A are not likely to result in difficulties for B. However, the controlling entity B needs to be considered in the group of A if B<sub>1</sub> forms such an important part of group B that B is economically dependent on B<sub>1</sub>. In such a case, financial difficulties of A will not only proceed “downwards”, but also “upwards” to B, i.e. causing payment difficulties of B (i.e. all entities now form a single risk).



Grouping requirement:



### 3.2.5 Control and management procedures in order to identify connected clients

33. It is in the institutions' interest to identify all possible connections among its clients to have a clear understanding of the risks it is exposed to. Institutions should investigate all potential connections among their clients. That said, the EBA acknowledges the inherent difficulties of identifying economic connections and recommends that institutions increase their efforts to identify (and document as appropriate) such economic connections for all exposures that reach an exposure value equal or above 2% of eligible capital<sup>17</sup>.
34. Having information about connected clients is essential to limit the impact of unforeseen events. In this regard, institutions should use all available information to identify connections; this includes publicly available information. The data that needs to be collected may go beyond the institutions' clients and include legal or natural persons connected to the client. The necessary inputs require utilising 'soft information' that typically exists at the level of individual loan officers and relationship managers. Institutions shall take reasonable steps to acquire this information.
35. In relation to the identification of interconnected clients, every institution should have in place a robust process for determining connected clients, although practical difficulties may arise in determining interconnections for all the exposures of an institution, in particular regarding economic dependencies. Notwithstanding this, an institution must be in a position to demonstrate to its competent authority that its process is commensurate to its business. In addition, the process should be subject to periodic review by institutions to ensure its appropriateness. Furthermore, institutions should also monitor for changes to interconnections, at least in the context of their periodic loan reviews and when substantial expansions of the loan are planned.
36. It is important to note that institutions need to have information on all entities forming a 'chain of contagion' to be able to correctly identify groups of connected clients. If there are interconnections among group members the institution has no business relation with (and thus has not collected any information with regard to possible interconnections), the correct identification of a group of connected clients might not be possible. However, if an institution becomes aware of such interconnections via entities outside its clientele (e.g. by press statements), it needs to incorporate this information in its grouping practice.

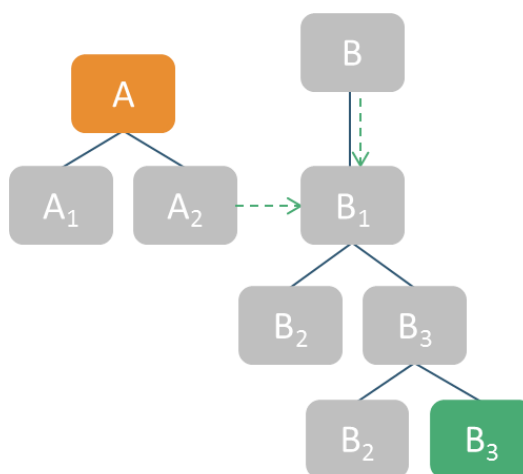
---

<sup>17</sup> The threshold of 2% relates to the institution's eligible capital (as defined in Article 4(1)(71) of Regulation (EU) No 575/2013) for the purposes of applying the large exposures requirements on an individual basis. The threshold relates to the group's eligible capital for the purposes of applying the large exposures requirements on a sub-consolidated or consolidated basis.

**Example Mm 1:** Limits to the identification of a chain of contagion

The current guidelines also make clear that there needs to be information on all entities forming a contagion chain. If there are interconnections stemming from entities the institution has no business relationship with (and thus has no information on possible interconnections) it is conceded that the institution will not be in a position to correctly form groups of connected clients which constitute a single risk.

Further developing the example above (C/E 2), the reporting institution has only exposures vis-à-vis entity A and entity B<sub>3</sub>. In such a case, it might not be possible to become aware of the chain of contagion and no group of connected clients might be formed.



37. It will rarely be possible to implement automated procedures for identifying economic interconnections; therefore, case by case analysis and judgement should be used.

38. Notwithstanding the above, all interconnections to the knowledge of an institution shall be recognised, independently of the size of the exposure. As the determination of economic interconnection is dependent on the one hand on the information available to, or gathered on a best effort 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. Supervisors should be aware of this issue and, subject to the specific case, may accept or challenge such differences.



## 4. Draft Guidelines

---

In between the text of the draft Guidelines that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

EBA/GL/20XX/XX

---

DD Month YYYY

---

## Draft Guidelines

---

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

# 1. Compliance and reporting obligations

---

## Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010<sup>18</sup>. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities and financial institutions must make every effort to comply with the guidelines.
2. Guidelines set the EBA view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. Competent authorities as defined in Article 4(2) of Regulation (EU) No 1093/2010 to whom guidelines apply should comply by incorporating them into their practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

## Reporting requirements

3. According to Article 16(3) of Regulation (EU) No 1093/2010, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by `[[dd.mm.yyyy]]`. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form available on the EBA website to [compliance@eba.europa.eu](mailto:compliance@eba.europa.eu) with the reference 'EBA/GL/201x/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities. Any change in the status of compliance must also be reported to the EBA.
4. Notifications will be published on the EBA website, in line with Article 16(3).

---

<sup>18</sup> Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, (OJ L 331, 15.12.2010, p.12).

## 2. Subject matter, scope and definitions

---

### Subject matter

5. These guidelines specify the approach institutions should take when applying the requirement to group two or more clients in a 'group of connected clients', for the purposes of Part Four of Regulation (EU) No 575/2013 (Large Exposures), because they constitute a single risk in accordance with Article 4(1)(39) of that Regulation.

### Scope of application

6. These guidelines apply to institutions to which Part Four of Regulation (EU) No 575/2013 (Large Exposures) applies, in accordance with the level of application set out in Part One, Title II, of the same Regulation.

### Addressees

7. These guidelines are addressed to competent authorities as defined in point (i) of Article 4(2) of Regulation (EU) No 1093/2010 and to financial institutions as defined in Article 4(1) of Regulation No 1093/2010.

### Definitions

8. Unless otherwise specified, terms used and defined in Regulation (EU) No 575/2013 and Directive 2013/36/EU have the same meaning in these guidelines.

## 3. Implementation

---

### Date of application

9. These guidelines apply from dd.mm.yyyy.

### Repeal

10. The CEBS 'Guidelines on the implementation of the revised large exposures regime', of 11 December 2009, are repealed with effect from xx month xxxx.

## 4. Group of connected clients based on control

---

11. For the purposes of Part Four of Regulation (EU) 575/2014 (Large Exposures) and in accordance with Article 4(1)(39)(a) of Regulation (EU) No 575/2013, institutions must group two or more clients, either natural or legal persons, who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other(s). For the purposes of applying this requirement, institutions must assume that two or more clients constitute a single risk when there is a control relationship between them, unless they are able to demonstrate that despite the existing control relationship these persons, by way of exception, do not constitute a single risk.
12. Where institutions are able to demonstrate that no single risk exists despite the existence of a control relationship among clients, they should document the relevant circumstances which justify this case in a detailed and comprehensible manner.

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

**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.**

13. Institutions must rely on the concept of control as defined in Article 4(1)(37) of Regulation (EU) No 575/2013. For this purpose, a control relationship between a parent undertaking and its subsidiaries should be understood as follows:
- a) In relation to clients which prepare their consolidated financial statements in conformity with the national rules transposing Directive 2013/34/EU<sup>19</sup>, institutions should rely on the control relationship between a parent undertaking and its subsidiaries within the meaning of Article 22(1) and (2) of Directive 2013/34/EU. For this purpose, institutions should group clients on the basis of their clients' consolidated financial statements. To this end, references to Directive 2013/34/EU should be understood as references to the national rules which transposed Directive 2013/34/EU in the Member State where the institutions' clients are required to prepare their consolidated financial statements.
  - b) In relation to clients which prepare their consolidated financial statements in conformity with the international accounting standards adopted by the Commission in accordance

---

<sup>19</sup> Article 22(1) and (2) of Directive 2013/34/EU has replaced the content of Article 1 of Directive 83/349/EEC, referred to in Article 4(1)(37) of Regulation (EU) No 575/2013. In accordance with Article 52 of Directive 2013/34/EU, references to the repealed directive must be construed as references to the Directive 2013/34/EU and must be read in accordance with the correlation table in its Annex VII.



with Regulation (EC) No 1606/2002, institutions should rely on the control relationship between a parent undertaking and its subsidiaries within the meaning of those accounting standards. For this purpose, institutions should group clients on the basis of their clients' consolidated financial statements.

**Explanatory Box:**

The EBA understands that the relevant accounting framework to be considered in the definition of control relationships, for the purposes of forming groups of connected clients, is the accounting framework that applies to the institution's clients. Given that the definition of control set out in Article 4(1)(37) of Regulation (EU) No 575/2013 points out to the accounting definition of a relationship between a parent undertaking and a subsidiary and the consequent preparation of consolidated financial statements, it makes sense that the accounting framework to be considered in this context is the one applicable to the institution's clients. In addition, this is the only way to ensure that clients will be connected in a consistent way by institutions in different Member States.

The relevant accounting standards are listed in Regulation (EC) No 1126/2008 as amended by Regulation (EU) No 1254/2012 whereby the IFRS 10 (*Consolidated financial statements*), which sets the rules for preparing and presenting consolidated financial statements when an entity controls one or more other entities, IFRS 11 (*Joint Arrangements*) and IFRS 12 (*Disclosure of Interests in Other Entities*) are of particular interest.

**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.**

- c) In relation to clients to which the EU accounting rules do not apply (e.g. natural persons, central governments, and clients which prepare consolidated financial statements in accordance with the accounting rules of a third country), institutions should deem as control relationships those between any natural or legal person and an undertaking which are similar to the parent undertaking/subsidiary relationships mentioned in points a) and b) of this paragraph. When conducting this assessment, institutions should consider the following non-exhaustive list of indicators of control:
- i. Holding the majority of the shareholders' or members' voting rights in another entity.
  - ii. Right or ability to appoint or remove a majority of the members of the administrative, management or supervisory body of another entity.
  - iii. Right or ability to exercise a dominant influence over another entity pursuant to a contract, or provision in its memorandum or articles of association. Other



indicators of dominant influence are for example, power to decide on the strategy or direct the activities of an entity, power to decide on crucial transactions such as the transfer of profit or loss, or holding a blocking minority and management duties in the other entity.

- iv. Right or ability to coordinate the management of an entity with that of other entities in pursuit of a common objective, for instance, in case where the same natural persons are involved in the management or board of two or more entities.
- v. Holding more than 50% of the shares of capital of another entity.

**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?**

14. When identifying clients that fall under the scope of paragraph 13 a) or b), institutions should examine whether they are aware of the existence of undertakings linked by a control relationship between a parent undertaking and its subsidiaries. This includes cases where the consolidated financial statements mention such relationships, but which were excluded from the consolidated financial statements by way of exemption (e.g. in accordance with Article 23 of Directive 2013/34/EU). Institutions should assess whether these clients need to be included in a group of connected clients on the basis of a control relationship between a parent undertaking and its subsidiaries within the meaning of Article 22(1) and (2) of Directive 2013/34/EU or the relevant accounting standards referred to in paragraph 13 b) as applicable.

**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?**

15. Institutions should group two or more clients in a group of connected clients due to a relationship of control or economic dependency between these clients regardless of whether the exposures to these clients are exempted or not from the application of the large exposures limit according to Article 400 (1) and (2) of Regulation (EU) No. 575/2013 or according to exemptions on a national basis implementing Article 493(3) of Regulation No. 575/2013.



## 5. Alternative approach for exposures to central governments

---

16. 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 in accordance with the last sub-paragraph of Article 4(1)(39) of Regulation (EU) No 575/2013 ('alternative approach').
17. Institutions may also partially apply the alternative approach, assessing separately the natural or legal persons directly controlled by or directly interconnected with the central government.
18. The central government must be 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.
19. Persons solely indirectly controlled by or indirectly interconnected with the central government must be included in the respective group of connected clients for the person directly controlled by or directly interconnected with the central government, which controls or is interconnected with the person in question.
20. 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.
21. The guidance in the previous paragraphs of this Section is also applicable to regional governments or local authorities to which Article 115 (2) of Regulation (EU) No 575/2013 applies, and natural or legal persons directly controlled by or interconnected with these regional governments or local authorities.

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

## 6. Establishing interconnectedness based on economic dependency

---

22. When assessing interconnectedness among their clients based on economic dependency in accordance with point (b) of Article 4(1)(39) of Regulation (EU) No 575/2013, institutions should take into account the specific circumstances of each case.

23. Institutions should deem, in particular, the following situations as constituting economic dependency:

- a) Where a client has fully or partly guaranteed the exposure of another client, or is liable by other means, and the exposure is so significant for the guarantor that the guarantor is likely to default or experience financial difficulties if a claim occurs.<sup>20</sup>
- b) Where a client is liable according to his legal status as a member in an entity, e.g. general partner in a limited partnership, and the exposure is so significant for the client that the client is likely to default or experience financial difficulties if a claim against the entity occurs.
- c) Where a significant part, or at least 50%, of a client's gross receipts or gross expenditures (on an annual basis) is derived from transactions with another client (e.g. the owner of a residential/commercial property and the tenant who pays a significant part of the rent).
- d) Where a significant part, or at least 50%, 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.
- e) When the expected source of repayment for each loan granted by the institution to two or more clients is the same and neither client has another source of income from which the loan may be fully repaid.
- f) Where a significant part, or at least 50%, of receivables or liabilities of a client is to another client.
- g) Where a significant part, or at least 50%, of a client's assets is invested in another client.

---

<sup>20</sup> This situation refers to guarantees which do not comply with the eligibility requirements provided for in Part Three, Title II, Chapter IV (Credit Risk Mitigation) of Regulation (EU) No 575/2013 and, consequently, where the substitution approach (referred to in Article 403 of that Regulation) cannot be used for prudential purposes.



- h) When clients have an identical customer base, consisting of a very small number of customers and where the potential for finding new customers is limited.
- i) When clients have common owners, shareholders or managers. For example, horizontal groups where an undertaking is related to one or more other undertakings because they all have the same shareholder structure without a single controlling shareholder or because they are managed on a unified basis. This management may be pursuant to a contract concluded between the undertakings, or to provisions in the Memoranda or Articles of Association of those undertakings, or if the administrative management or supervisory bodies of the undertaking and of one or more other undertakings consist for the major part of the same persons.
- j) The relationship between a debtor and his/her co-borrower.
- k) The relationship between a debtor and his/her spouse/partner if by contractual arrangements or marriage laws both are liable and the loan is significant for both.

**Explanatory Box:**

The present guidelines follow the wording of point (b) of Article 4(1)(39) of Regulation (EU) No 575/2013 very closely and consider that if the failure of a client would lead to '*repayment difficulties*' of another client an institution should regard these clients as a group of connected clients.

**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.**

**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)?**

The EBA is considering whether additional cases should be added to the list of situations that constitute economic dependency. For example, situations 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.<sup>21</sup>

**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.**

<sup>21</sup> This situation refers to cases where the substitution approach referred to in Article 403 of Regulation (EU) No 575/2013) is not used.



24. Institutions should consider the non-exhaustive list of situations in paragraph 23 also when assessing connections among shadow banking entities.<sup>22</sup> Institutions should give due consideration to the fact that relationships between entities falling under the definition of shadow banking entity will most likely not consist of equity ties but rather of a different type of relationship, i.e. situations of *de facto* control or identifiable by contractual obligations, implicit support, or potential reputational risk (such as sponsorship or even branding).
25. Where an institution's client is economically dependent on more than one other client which are not dependent on each other, the institution should include the former in each group of connected clients.
26. Institutions should form a group of connected clients where two or more of their clients are economically dependent on an entity, even if this entity is not a client of the institution.

## Economic dependency through a main source of funding

27. Institutions should consider situations where funding problems of one client are likely to spread to another due to a one-way or two-way dependency on the same funding source. This does not include cases where the respective clients get funding from the same market (e. g. the market for commercial paper).
28. Institutions should consider cases where the dependency on a common source of funding is provided by the institution itself, its financial group or its connected parties.
29. Institutions should also assess any contagion or idiosyncratic risk that could emerge from the following situations:
- a) use of one funding entity (e.g. the same bank or conduit that cannot be easily replaced);
  - b) use of the same investment advisor (e.g. investment committee);
  - c) use of similar structures;
  - d) reliance on commitments from one source (such as guarantees, credit support in structured transactions or non-committed liquidity facilities) and its solvency, especially where there are maturity mismatches between the maturity of underlying assets and the frequency of the refinancing needs; and
  - e) use of similar underlying assets.

---

<sup>22</sup> As defined in the EBA guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No 575/2013: <https://www.eba.europa.eu/regulation-and-policy/large-exposures/guidelines-on-limits-on-exposures-to-shadow-banking>

## 7. Relation between interconnectedness through control and interconnectedness through economic dependency

---

30. Institutions should first identify which clients are connected via control in accordance with Article 4(1)(39)(a) of Regulation (EU) No 575/2013 ('control group') and which clients are connected via economic dependency in accordance with Article 4(1)(39)(b) of the same Regulation. Subsequently, institutions should assess whether the identified groups of connected clients need to be (partially) connected themselves (e.g. whether groups of connected clients based on economic dependency need to be grouped together with a control group).
31. In their assessment, institutions should consider each case separately, i.e. identify the possible chain of contagion ('domino effect') based on the individual circumstances.
32. 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. Downstream contagion should always be assumed when a client is economically dependent and itself the head of a control group. Upstream contagion of clients that control an economically dependent entity should only be assumed when this controlling client is also economically dependent on the entity that constitutes the economic link between the two controlling groups.

**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.**

## 8. Control and management procedures to identify connected clients

---

33. Institutions should have a thorough knowledge of their clients and their clients' relationships and ensure that their staff understands and applies these guidelines.
34. Identification of possible connections among clients should be an integral part of the institution's credit granting and surveillance process. The management body and senior management should ensure that adequate processes for the identification of interconnections among clients are documented and implemented.
35. Institutions should investigate potential economic connections among their clients to the extent possible. Institutions should intensively investigate potential economic connections for at least the exposures with an exposure value equal or above 2% of eligible capital<sup>23</sup> and document these connections as appropriate.
36. Institutions should take reasonable steps and use all available information to identify connections, including 'soft information' as well as information that go beyond the institutions' client. Information should permit to capture business links or economic dependencies. If an institution becomes aware that clients have been considered as interconnected by another institution (e.g. due to the existence of a public register) it should take into account that information.
37. 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. If an institution becomes aware of interconnections via entities outside its clientele, it should use this information when assessing connections.
38. Control and management procedures to identify connected clients should be subject to periodic review to ensure its appropriateness. Institutions should also monitor changes to interconnections, at least in the context of their periodic loan reviews and when substantial increases of a loan are planned.

---

<sup>23</sup> The threshold of 2% relates to the institution's eligible capital (as defined in Article 4(1)(71) of Regulation (EU) No 575/2013) for the purposes of applying the large exposures requirements on an individual basis. The threshold relates to the group's eligible capital for the purposes of applying the large exposures requirements on a sub-consolidated or consolidated basis..

## 5. Accompanying documents

---

### 5.1 Draft cost-benefit analysis / impact assessment

#### A. Problem identification

The 'guidelines on the implementation of the revised large exposures regime' issued by the Committee of European Banking Supervisors (CEBS) on 11 December 2009 aimed at ensuring the harmonised implementation of that regime across Member States (2009 CEBS Guidelines).

However, since then, the large exposures regime has been amended by Regulation (EU) No 575/2013 and complemented by the European Commission's regulations and the European Banking Authority's (EBA) guidelines. To ensure consistency with those regulations and guidelines and avoid overlaps, the EBA found it necessary to review and update the 2009 CEBS Guidelines. This review also needed to take into account developments in the area of shadow banking and large exposures at Union and international level.

#### B. Policy objectives

The large exposures regime constitutes a backstop regime designed to limit the impact of a client's failure on an institution. The assessment of the existence of a 'group of connected clients' is a key aspect of the large exposures regime as it is aimed at identifying clients so closely linked by idiosyncratic risk factors that it is prudent to treat them as a single risk. Idiosyncratic risk represents the effect of risks that are specific to individual counterparties. Idiosyncratic risk arises where, in a bilateral interrelationship, financial problems of one entity are transferred via this interrelationship to another entity which otherwise would not be concerned.

Consequently, the purpose of the guidelines is to clarify, operationalise and harmonise the application of the concept of interconnection, in particular when control issues or economic dependency should lead to the grouping of clients because they constitute a single risk in accordance with Article 4(1)(39) of Regulation (EU) No 575/2013.

#### C. Baseline scenario

The starting point for the review, which resulted in the guidelines included in the Consultation Paper, were the current Articles 4(1)(37) and (39) of Regulation (EU) No 575/2013 and the 2009 CEBS Guidelines.



## D. Options considered

Option 1: Keep (Part I of) the 2009 CEBS Guidelines.

Option 2: Review and update the 2009 CEBS Guidelines.

**Option 2** was the preferred option due to the following:

- The new Accounting Directive 2013/34/EU replaced Directive 83/349/EC mentioned in Article 4(1)(37) of Regulation (EU) No 575/2013, which lead to the need for an update of the guidelines ;
- Changes to Article 4(1)(39) of Regulation (EU) No 575/2013, i.e. introduction of the last sub-paragraph of Article 4(1)(39) of Regulation (EU) No 575/2013 which provided an alternative approach for the assessment of the existence of groups of connected clients of entities directly controlled by or directly interconnected with the central government (or regional or local governments to which Article 115(2) of Regulation (EU) No 575/2013 applies), lead to the need for an update of the guidelines;
- Other European Commission regulations overlapped with some points of the 2009 CEBS Guidelines; and
- The experience in the application of the 2009 CEBS Guidelines lead to the identification of certain aspects of the guidelines that needed to be revised or clarified.

## E. Cost-Benefit Analysis

The main changes from the 2009 CEBS Guidelines are the following:

- Regarding the assessment of connections based on control, the guidelines clarify that institutions should make use of their clients' consolidated financial statements. This follows from the reading of Article 4(1)(37) of Regulation (EU) No 575/2013.

This clarification should alleviate the burden of identifying relations of control but will imply that institutions have access to and make use of their clients' consolidated financial statements. There might be a disproportionate cost regarding the assessment of the existence of control relationships in the case of subsidiaries excluded from the consolidated financial statements by way of exemption. Respondents are therefore asked to provide input.

- The guidelines clarify that only in *exceptional* cases the existence of a control relationship does not lead to a 'single risk'. It is unlikely that there is a significant number of current cases where the existence of a control relationship does not lead to a 'single risk'. In any





case, respondents are asked to provide input regarding the relevance of such cases and any costs associated with this proposal.

- New guidance regarding the use of the alternative approach, introduced by the last subparagraph of Article 4(1)(39) of Regulation (EU) No 575/2013, has been included. This will provide guidelines for the assessment of the existence of groups of connected clients of entities directly controlled by or directly interconnected with the central government (or regional or local governments to which Article 115(2) of Regulation (EU) No 575/2013 applies). The guidelines only clarify how this preferential treatment works in cases where institutions wish to apply it. The guidance provided should not lead to additional costs to institutions, but provide benefits in terms of a clear and harmonised understanding of the alternative approach.
- Regarding the assessment of economic dependency, the present guidelines recognise that it is sufficient when the failure of a client would lead to *'repayment difficulties'* of another client to form a group of connected clients, which is aligned with Article 4(1)(39)(b) of Regulation (EU) No 575/2013. This is more prudent than the 2009 CEBS Guidelines, which referred to *'substantial, existence-threatening repayment difficulties'*. Respondents are asked to provide input regarding any costs associated with this proposal.
- The guidelines also clarify situations where control and economic dependencies are interlinked and can therefore lead to the existence of one group of connected clients as opposed to two separate groups of connected clients. The 2009 CEBS Guidelines did not explicitly state that interconnections between control groups and economically dependent entities needed to be established especially when there was a downstream chain of contagion. The wording was more open and led to different interpretations and particularly the misconception that the non-grouping of controlled and economically dependent entities was the rule and grouping the exception. Respondents are asked to provide input regarding any costs associated with this proposal.

## 5.2 Overview of questions for consultation

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

**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.

**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.

**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?

**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?

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

**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.

**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)?

**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.

**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.