



# Consultation on Draft Guidelines on Connected Clients

Public Hearing, 5 September 2016

# Introduction



- The CEBS ‘Guidelines on the implementation of the revised large exposures regime’ of 2009 provided guidance regarding three aspects:
  - *Connected clients*
  - *Treatment of schemes with exposures to underlying assets* – replaced by the RTS on determination of overall exposures to a client or a group of connected clients in respect of transactions with underlying assets
  - *Reporting of large exposures* – replaced by the ITS on Supervisory Reporting
- Amendments to the CRR (e.g. introduction of an alternative approach to treat exposures to Central Governments), the new EBA GL on limits to exposures to shadow banking entities, and practical experience in the implementation of the CEBS GL.



- **Review and update of the 2009 CEBS GL, focusing exclusively on the issue of connected clients** (Article 4(1)(39) of the CRR). It covers the two types of interconnection that could lead to a ‘group of connected clients’: control relationships and economic dependency.

# Groups of connected clients based on control



## EBA Draft GL

- Institutions should use their clients' consolidated financial statements (when prepared in accordance with EU accounting rules)
- For other clients: updated list of control indicators (based on accounting indicators, CEBS GL and current practices of a sample of institutions). E.g. holding the majority of shareholders' or members' voting rights; right or ability to exercise a dominant influence over another entity; right or ability to coordinate the management of an entity with that of other entities; etc.
- *Disproportionate cost in the case of subsidiaries excluded from the consolidated financial statements by way of exemption?*
- Institutions must demonstrate that, despite the existence of control among clients, these clients do not constitute a single risk, by way of *exception* (a more prudent treatment aligned with level 1 text). *Any relevant impact?*

## 2009 CEBS GL

- Mentions the accounting definition of control, but do not explicitly require that institutions make use of their clients' consolidated financial statements
- Includes a non-exhaustive list of control indicators based on accounting indicators
- Did not emphasise this situation as an *exception* to the rule of connecting clients due to control relationships

## Alternative approach for exposures to central governments



- An ‘alternative approach’ to treat exposures to central governments (or regional or local governments to which Article 115(2) of the CRR applies), has been introduced by the CRR review → need to completely redraft this part of the 2009 CEBS GL
- The use of this ‘alternative approach’ is left to the choice of the institutions, but Q&As from institutions showed the need for detailed guidance.
- This ‘alternative approach’ permits a separate assessment for natural or legal persons directly controlled by or directly interconnected with the central government, allowing the formation of separate groups of connected clients (always including the central government) instead of one group of connected clients.
- Note that where the entities directly controlled by or directly interconnected with the central government are economically dependent on each other, they should form additional separate groups of connected clients (excluding the central government).

# Establishing interconnectedness based on economic dependency (1)



## EBA Draft GL

- Develop the non-exhaustive list of situations of economic dependency that was included in the 2009 CEBS GL (see next slide)
- Make clear that two clients form a group of connected clients if the failure of a client would lead to *'repayment difficulties'* of the other client (more prudent treatment aligned with level 1 text). *Any relevant impact?*
- The guidance regarding common sources of funding is in substance the same as in the 2009 CEBS GL

## 2009 CEBS GL

- Include a non-exhaustive list of situations of economic dependency
- Mention that two clients form a group of connected clients if the failure of a client would lead to *'substantial, existence-threatening repayment difficulties'* of the other client

## Establishing interconnectedness based on economic dependency (2)



For example, the following situations constitute economic dependency:

- 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.
- 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.
- 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).
- 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.

## Establishing interconnectedness based on economic dependency (3)



For example, the following situations constitute economic dependency (ctd):

- 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.
- a significant part, or at least 50%, of receivables or liabilities of a client is to another client.
- a significant part, or at least 50%, of a client's assets is invested in another client.
- clients have an identical customer base, consisting of a very small number of customers and where the potential for finding new customers is limited.
- clients have common owners, shareholders or managers (e.g. horizontal groups).
- The relationship between a debtor and his/her co-borrower.
- 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.

# Relation between control and economic dependency



## EBA Draft GL

- 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 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. *Any relevant impact?*

## 2009 CEBS GL

- The wording was more open and did not explicitly state that especially interconnections between control groups and economically dependent entities needed to be established when there was a downstream chain of contagion. This 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.



## Control and management procedures

- The guidance on control and management procedures to identify connected client is broadly similar to the 2009 CEBS GL.
- An institution should identify all possible connections among its clients to have a clear understanding of the risks it is exposed to.
- However, it might be difficult to identify all economic connections. The GL 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. This threshold was kept from the 2009 CEBS GL.
- Note that one of the aspects considered in the current review of the large exposures regime, is the possible change of capital basis of the large exposures regime, i.e. Tier 1 capital instead of eligible capital (sum of Tier 1 capital and Tier 2 capital up to 1/3 of Tier 1 capital). This review will likely have an impact on the design of the threshold of *2% of eligible capital*.

## Next steps



- Public consultation closes on 26 October 2016. Your feedback, concrete suggestions and data on any potential costs and benefits are most welcomed.
- Process the feedback from the consultation and finalise the guidelines in Q1 2017.
- Guidelines to apply shortly after their translation to all EU languages – Q2/Q3 2017.
- Competent authorities to implement the guidelines in their supervisory processes and legal frameworks; institutions to comply with the guidelines.

# Questions?

- Control and alternative approach to treat exposures to central governments
- Economic dependency
- Relation between control and economic dependency
- Control and management procedures
- Wrap-up



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