

## **ANNEX 1**

### **CONNECTED CLIENTS UNDER ARTICLE 4(1)(39) OF REGULATION (EU) NO 575/2013**

#### **INTRODUCTION**

1. This Annex focuses on the treatment of connected clients as defined in Article 4(1)(39) of the CRR and clarifies and operationalises 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 the CRR.

#### **SCOPE AND APPLICATION**

2. This Annex applies to all credit institutions that are licensed under the Act and is implementing the European Banking Authority (EBA) Guidelines on connected clients under Article 4(1)(39) of Regulation (EU) No 575/2013 ('the Guidelines'), issued on 14 November 2017.
3. The scope of this Annex is to specify the approach which credit institutions, as defined under Article 2 of the Act, shall take in applying the requirement to group two or more clients into a 'group of connected clients' because they constitute a single risk in accordance with Article 4(1)(39) of the CRR. Credit institutions shall refer to the Annex of the EBA Guidelines for the illustration of scenarios related to the application of the provisions of this Annex.
4. Two types of interconnection are considered in the definition of connected clients in Article 4(1)(39) of the CRR:
  - i) clients that are directly or indirectly interconnected by a control relationship as defined in Article 4(1)(37) of the same Regulation; and
  - ii) clients that are interconnected by some form of economic dependency as set out in Article 4(1)(39)(b), *inter alia*:
    - direct economic dependencies such as supply chain links or dependence on large customers; or
    - a common main source of funding in the form of credit support, potential funding or direct, indirect or reciprocal financial assistance.

5. This Annex applies to all areas of the CRR where the concept of connected clients is used, i.e. the large exposures regime (Part Four of the CRR), the categorisation of clients in the retail exposure class for the purposes of credit risk (Article 123(c) and Article 147(5)(a)(ii)), the development and application of rating systems (Article 172(1)(d)) and the SME supporting factor (Article 501(1)(c)).

#### **GROUPS OF CONNECTED CLIENTS BASED ON CONTROL**

6. In applying Article 4(1)(39) of the CRR, credit institutions shall assume that two or more clients constitute a single risk when there is a control relationship between them.
7. In exceptional cases, where credit institutions are able to demonstrate that no single risk exists despite the existence of a control relationship among clients, credit institutions shall document the relevant circumstances that justify this case in a detailed and comprehensible manner.
8. Credit institutions shall apply the concept of control as defined in Article 4(1)(37) of the CRR as follows:
  - a) In relation to clients that prepare their consolidated financial statements in conformity with the Companies Act 1996, credit institutions shall rely on the control relationship between a parent undertaking and its subsidiaries within the meaning of Article 13(1) and 13A(1)-(3) of the Act. For this purpose, credit institutions shall group clients accordingly on the basis of their clients' consolidated financial statements.
  - b) In relation to clients that prepare their consolidated financial statements in conformity with the international accounting standards adopted by the Commission in accordance with Regulation (EC) No 1606/2002, credit institutions shall rely on the control relationship between a parent undertaking and its subsidiaries within the meaning of those accounting standards. For this purpose, credit institutions shall group clients accordingly on the basis of their clients' consolidated financial statements.
  - c) In relation to clients to which point (a) or point (b) of this paragraph do not apply (e.g. natural persons, central governments, and clients that prepare consolidated financial statements in accordance with the accounting rules of a third country), credit institutions shall deem relationships between any natural or legal person and an undertaking that are similar to the parent undertaking/subsidiary relationships mentioned in points (a) and (b) of this paragraph to be control relationships.

When conducting this assessment, credit institutions shall deem any of the following criteria to constitute a control relationship:

- 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 provisions in memoranda or articles of association.

Other possible indicators of control that credit institutions shall consider in their assessment include the following:

- iv. power to decide on the strategy or direct the activities of an entity;
  - v. power to decide on crucial transactions, such as the transfer of profit or loss;
  - vi. right or ability to coordinate the management of an entity with that of other entities in pursuit of a common objective (e.g. where the same natural persons are involved in the management or board of two or more entities);
  - vii. holding more than 50% of the shares of capital of another entity.
9. Given that the decisive factor for the assessment of the existence of a control relationship is the accounting criteria or indicators of control set out in paragraph 8(a), (b) and (c), credit institutions shall group two or more clients on account of a relationship of control even where these clients are not included in the same consolidated financial statements as a result of exemptions applied to them under the relevant accounting rules.
10. Credit institutions shall group two or more clients into a group of connected clients on account of a relationship of control among these clients regardless of whether or not the exposures to these clients are exempted from the application of the large exposures limit under Article 400(1) and (2) of the CRR or in accordance with exemptions under Regulation 6(2) of S.L. 371.17 on the CRR (Implementing and Transitional Provisions) Regulations.

#### **ALTERNATIVE APPROACH FOR EXPOSURES TO CENTRAL GOVERNMENTS**

11. In line with the definition of 'group of connected clients', credit institutions may assess the existence of a group of connected clients separately for each of the persons

directly controlled by or directly interconnected with the central government ('alternative approach').

12. Article 4(1)(39) of the CRR allows for a partial application of the alternative approach, assessing separately the natural or legal persons directly controlled by or directly interconnected with the central government.
13. The same provision of the CRR also makes clear that:
  - a) The central government is included in each of the groups of connected clients identified separately for the natural or legal persons directly controlled by or directly interconnected with the central government.
  - b) Each group of connected clients under point (a) includes also persons controlled by or interconnected with the person who is directly controlled by or directly interconnected with the central government.
14. Where entities are directly controlled by or directly interconnected with the central government and 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.
15. By virtue of the last sentence of the last subparagraph of Article 4(1)(39) of the CRR, paragraphs 11 to 14 are also applicable to regional governments or local authorities to which Article 115(2) of the CRR applies, and natural or legal persons directly controlled by or interconnected with these regional governments or local authorities.

#### **ESTABLISHING INTERCONNECTEDNESS BASED ON ECONOMIC DEPENDENCY**

16. When assessing interconnectedness among their clients based on economic dependency, in accordance with Article 4(1)(39)(b) of the CRR, credit institutions shall take into account the specific circumstances of each case, in particular whether the financial difficulties or the failure of a client would lead to funding or repayment difficulties for another client.
17. In the event that an institution is able to demonstrate that the financial difficulties or the failure of a client would not lead to funding or repayment difficulties for another client, these clients need not be considered as a single risk. In addition, two clients need not be considered a single risk if a client is economically dependent on another

client in a limited way, in that the client can easily find a replacement for the other client.

18. An institution shall consider, in particular, the following situations when assessing economic dependency:

- a. Where a client has fully or partly guaranteed the exposure of another client and the exposure is so significant for the guarantor that the guarantor is likely to experience financial problems if a claim occurs. (This situation refers to guarantees that 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, in relation to which the substitution approach (referred to in Article 403 of that Regulation) cannot be used for prudential purposes).
- b. Where a client is liable in accordance with his or her legal status as a member in an entity, and the exposure is so significant for the client that the client is likely to experience financial problems if a claim against the entity occurs.
- c. Where a significant part 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 the tenant of which pays a significant part of the rent) that cannot be easily replaced.
- d. Where a significant part of a client's production/output is sold to another client of the institution, and the production/output cannot be easily sold to other customers.
- e. Where the expected source of funds to repay the loans of two or more clients is the same and none of the clients has another independent source of income from which the loan may be serviced and fully repaid.
- f. Other situations where clients are legally or contractually jointly liable for obligations to the institution (e.g. a debtor and his or her co-borrower, or a debtor and his or her spouse/partner).
- g. Where a significant part of the receivables or liabilities of a client is to another client.
- h. Where 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.

19. Credit institutions shall consider the non-exhaustive list of situations in paragraph 18 when assessing connections among shadow banking entities. Credit institutions shall give due consideration to the fact that relationships between entities falling under the definition of shadow banking entities will most likely not consist of equity ties but rather of situations of de facto control or relationships characterised by contractual obligations, implicit support or potential reputational risk (e.g. sponsorship or even branding).
20. If an institution's client is economically dependent on more than one client, which are not dependent on each other, the institution shall include the latter clients in separate groups of connected clients (together with the dependent client).
21. Credit institutions shall 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.
22. Credit institutions shall group two or more clients into a group of connected clients on account of economic dependency among these clients regardless of whether or not the exposures to these clients are exempted from the application of the large exposures limit under Article 400(1) and (2) of the CRR or in accordance with exemptions under Regulation 6(2) of the CRR (Implementing and Transitional Provisions) Regulations.

#### **ECONOMIC DEPENDENCY THROUGH A MAIN SOURCE OF FUNDING**

23. Credit institutions shall consider situations where the funding problems of one client are likely to spread to another on account of a one-way or two-way dependency on the same funding source. This does not include cases where clients get funding from the same market or where clients' dependency on their existing source of funding is caused by the clients' deteriorating creditworthiness, such that they cannot easily replace that source of funding.

24. Credit institutions shall consider cases where the common source of funding depended on is provided by the credit institution itself, its financial group or its connected parties. Being clients of the same credit institution does not in itself create a requirement to group the clients if the credit institution providing funding can be easily replaced.
25. Credit institutions shall 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 similar structures;
  - c. reliance on commitments from one source (e.g. guarantees, credit support in structured transactions or non-committed liquidity facilities), taking into account its solvency, especially where there are maturity mismatches between the maturity of underlying assets and the frequency of the refinancing needs.

**RELATION BETWEEN INTERCONNECTEDNESS THROUGH CONTROL AND INTERCONNECTEDNESS THROUGH ECONOMIC DEPENDENCY**

26. Credit institutions shall first identify which clients are connected via control in accordance with Article 4(1)(39)(a) of the CRR ('control group') and which clients are connected via economic dependency in accordance with Article 4(1)(39)(b) of the same Regulation. Subsequently, credit institutions shall assess whether the identified groups of connected clients need to be (partially) connected themselves.
27. In their assessment, credit institutions shall consider each case separately, identifying any possible contagion ('domino effect') based on the individual circumstances.
28. 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 shall always be assumed when a client is economically dependent and is itself the head of a control group. Upstream contagion of clients that control an economically dependent entity should be assumed only when this controlling client is also economically dependent on the entity that constitutes the economic link between the two controlling groups.

## **CONTROL AND MANAGEMENT PROCEDURES FOR IDENTIFYING CONNECTED CLIENTS**

29. Credit institutions shall have a thorough knowledge of their clients and their clients' relationships. Credit institutions shall also ensure that their staff understand and apply this Annex.
30. Identification of possible connections among clients shall be an integral part of a credit institution's credit granting and surveillance process. The Board of Directors and senior management shall ensure that adequate processes for the identification of connections among clients are documented and implemented.
31. Credit institutions shall identify all control relationships among their clients and document as appropriate. Credit institutions shall also investigate, and document as appropriate, any potential economic dependencies among their clients. Credit institutions shall take reasonable steps and use readily available information to identify these connections. If, for example, a credit institution becomes aware that clients have been considered interconnected by another credit institution it shall take into account that information.
32. The efforts that credit institutions put into the investigation of economic dependencies among their clients shall be proportionate to the size of the exposures. Therefore, credit institutions shall strengthen their investigations, by extensive research of any type of 'soft information' as well as information that goes beyond the credit institutions' clients, in all cases where the sum of all exposures to one individual client exceeds 5% of Tier 1 capital.
33. To assess grouping requirements based on a combination of control and economic dependency relationships, credit institutions shall collect information on all entities forming a chain of contagion. Credit institutions might not be able to identify all clients that constitute a single risk if there are interconnections that stem from entities that are not in a business relationship with the credit institution and are therefore unknown to the credit institution. However, if a credit institution becomes aware of interconnections via entities outside its clientele, it should use this information when assessing connections.
34. Control and management procedures for identifying connected clients shall be subject to a periodic review to ensure their appropriateness. Credit institutions shall also monitor changes to interconnections, at least in the context of their periodic loan reviews and when a substantial increase to a loan is planned.