

Financial Stability Institute

FSI Insights on policy implementation No 52

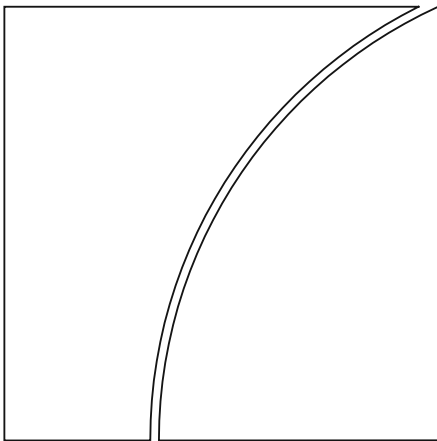
Challenges in supervising banks' large exposures

By Vasily Pozdyshev, Jean-Philippe Svoronos and
Rize-Mari van Zyl

November 2023

JEL classification: G21, G28

Keywords: finance, bank lending, commercial banks,
bank regulation, standard, supervision



BANK FOR INTERNATIONAL SETTLEMENTS

FSI Insights are written by members of the Financial Stability Institute (FSI) of the Bank for International Settlements (BIS), often in collaboration with staff from supervisory agencies and central banks. The papers aim to contribute to international discussions on a range of contemporary regulatory and supervisory policy issues and implementation challenges faced by financial sector authorities. The views expressed in them are solely those of the authors and do not necessarily reflect those of the BIS or the Basel-based committees.

Authorised by the Chair of the FSI, Fernando Restoy.

This publication is available on the BIS website (www.bis.org). To contact the BIS Media and Public Relations team, please email media@bis.org. You can sign up for email alerts at www.bis.org/emailalerts.htm.

© *Bank for International Settlements 2023. All rights reserved. Brief excerpts may be reproduced or translated provided the source is stated.*

ISSN 2522-249X (online)

ISBN 978-92-9259-699-6 (online)

Contents

Executive summary	1
Section 1 – Introduction	3
Section 2 – Main features and challenges associated with the LEX standard.....	5
Section 3 – The challenges of identifying connected counterparties.	7
Regulatory definition and assessment criteria for connected counterparties.....	7
Section 4 – Approaches for specific types of exposures	13
Approach to intragroup exposures.....	13
Related-party lending (RPL) – a “grey area”?.....	15
Interbank exposures.....	17
Section 5 – Credit risk mitigation (CRM) techniques and challenges.....	24
Eligibility of CRM techniques.....	25
Challenges related to assessing the effectiveness of CRM techniques.....	25
Section 6 – Reporting and supervisory monitoring.....	26
Reporting requirements and practices.....	26
Section 7 – Breaches, supervisory measures and return to compliance.	27
Identifying breaches.....	28
Analysing breaches.....	29
Corrective measures.....	30
Time frames to return to compliance: theory and practice.....	32
Section 8 – Conclusions.....	34
References.....	35

Challenges in supervising banks' large exposures¹

Executive summary

Recent failures to manage counterparty risk serve as a reminder of the need to control and limit risk concentrations. The origin of the failure of Archegos Capital Management, a family office of a former hedge fund manager, can be found in the concentrated risk exposures that it built up and mismanaged. Archegos built large and highly leveraged equity positions through total return equity swaps with several banks who were unaware of its overall positions and had also, in the case of Credit Suisse in particular, insufficiently collateralised their exposure to the family office. When the value of these positions contracted sharply, Archegos defaulted on its margin calls, with several of the exposed banks suffering large losses.

Regulators have long recognised the need to prevent banks from becoming overexposed to a single counterparty. This is because such a concentration exposes a bank to disproportionately large losses should this counterparty fail. Accordingly, the need to limit the size of these exposures is a fundamental principle of prudential regulation and ensuring that banks abide by such regulation is a core component of banking supervision. This principle forms the basis of the large exposures (LEX) standard issued by the Basel Committee on Banking Supervision (BCBS), which complements the risk-based capital standards.

Multiple supervisory challenges make this standard difficult to enforce and partly explain the wide ranges of jurisdictional practices. These challenges, difficulties and ranges of practices relate to the supervisory authority's ability to conduct case by case assessments and use its supervisory judgment as such assessments are needed throughout the standard. Challenges include those related to the ability to determine whether exposures are connected or not; whether exposures fall within the scope of the standard or constitute special cases that warrant specific treatments or exemptions; whether and to what extent exposures are mitigated; and how to treat breaches. These challenges, and how supervisory authorities have sought to overcome them, are discussed in this paper.

The first set of challenges is to identify and assess groups of connected counterparties. Connected counterparties are those that have relationships such that, should one of the counterparties fail, the others would very likely fail. Establishing interconnectedness generates an assumption that exposures to these counterparties constitute a single risk. To determine whether counterparties are connected, banks must use control relationship criteria and economic dependence criteria. In practice, establishing interconnectedness does not always lead to aggregating the exposures. This is because the criteria may not be sufficient to establish a connection between the counterparties or because the connection is not sufficiently strong to consider that the exposures constitute a single risk. When this takes place, the supervisor determines whether the exposures constitute a single risk or not based on the bank's analysis.

Another set of challenges is the lack of common criteria applicable to all exposures. There are various approaches that are specific to certain exposures under the LEX standard, and specific approaches may need to be designed to address jurisdictional challenges. Examples of specific treatments include the valuation of trading book positions. Exemptions include entities connected with sovereigns or intraday bank exposures. Examples of jurisdiction-specific treatments relate to intra-banking group

¹ Vasily Pozdyshev (Vasily.Pozdyshev@bis.org), Jean-Philippe Svoronos (Jean-Philippe.Svoronos@bis.org), Bank for International Settlements, and Rize-Mari van Zyl (Rize-Mari.vanZyl@resbank.co.za), South African Reserve Bank Prudential Authority. The authors are grateful to Rodrigo Coelho and Jatin Taneja for helpful comments. We are also grateful to Anna Henzmann and Marie-Christine Drexler for valuable administrative support with this paper.

exposures or to supervisory carve-outs which may be temporarily granted in special situations such as mergers and acquisitions and resolution.

The complexity involved in assessing credit risk mitigation (CRM) techniques is an additional challenge for supervisors. While the LEX standard requires that banks report both gross and net large exposures, additional information is necessary to enable a supervisor to check the effectiveness of CRM instruments. To ensure that the instruments provide sufficient legal certainty to be eligible as CRM techniques, the supervisor would need to review all relevant contractual documentation for all instruments used. For financial collateral, this would include verifying the collateral's existence, that it is effectively available and unpledged, and that it is prudently valued. For guarantees, this would imply the ability to assess the credit quality and financial position of the guarantor and, for credit derivatives, the need to verify and ensure that the underlying reference entity and default events are such that the protection would effectively be triggered, and the pay-out would take place should the bank's counterparty default.

The treatment of breaches constitutes a final set of challenges. While limit breaches are meant to be exceptional and should be reported and addressed immediately, this is not always the case in practice. A supervisor typically becomes aware of a breach when it is informed by the bank. Force majeure and unpredictability may qualify a breach as exceptional because it was caused by reasons beyond the bank's control or because it was unforeseeable by the bank. However, there are also breaches caused by risk management deficiencies, faulty controls, or poor governance. Although contents vary, remediation plans typically include three types of measures. These are measures to reduce the size of the exposure or increase the bank's capital position, ones to reinforce the bank's risk management and internal controls, and ones to ensure the plan's execution. For non-exceptional breaches, remediation plans are combined with corrective measures, more intensive supervision, possible downgrades of the supervisory rating and fines.

Automated tools could increase the efficiency of supervisory oversight. The supervisory challenges associated with the standard's implementation are such that supervisory authorities do not have the resources to ensure that all large exposures at all reporting banks are comprehensively controlled. Several jurisdictions are therefore considering or developing automated tools to address these limitations. Tools include automated cross-checks across banks to compare groups of interconnected exposures declared by banks. A supervisory database containing groups of connected counterparties could constitute a common supervisory tool that would help to ensure consistent reporting across banks and jurisdictions. Another type of tool would be one allowing a supervisory authority to identify exposures and situations that may lead to breaches.

International cooperation and guidance could promote the sharing and development of common supervisory practices. This could include sharing interconnectedness case studies and additional interconnectedness criteria based on supervisory practices. International guidance could be useful for harmonising practices related to the detection, analysis and resolution of limit breaches and harmonising reporting requirements for periodic reporting and breach reporting. There could also be value in developing common reporting templates and guidelines that would lay out how the standard should be enforced by supervisory authorities.

Section 1 – Introduction

- 1. Regulators have long recognised the need to prevent banks from becoming overexposed to a single counterparty or a group of connected counterparties.** This need is encapsulated in the old saying according to which you should not “put all your eggs in one basket”.² The reason for this is that risks concentrated on a counterparty expose a bank to disproportionately large losses should this counterparty fail. Moreover, overexposure to a counterparty or groups of related counterparties can also threaten the stability of the financial system when several banks hold similar concentrated exposures.
- 2. One of the fundamental principles of prudential supervision³ is therefore to ensure that risks arising from large exposures to counterparties are limited to an acceptable level.** This acceptable level needs to be commensurate with the size, nature, and complexity of the bank. The Basel Committee on Banking Supervision (BCBS) has highlighted the importance of limiting credit risk concentrations. This is because “a significant proportion of major bank failures have been due to credit risk concentration of one kind or another”.⁴ Risk concentrations can arise from different types of financial risk, including market risk, because of concentrated trading positions; liquidity risk, because of funding concentrations; and operational risks. While the main source of bank failures resulting from risk concentrations has historically been, and remains, credit risk, other risk concentrations on the asset and/or liability side can also compromise a bank’s viability.⁵
- 3. The failure of Archegos Capital Management illustrates the importance of carefully managing risk concentrations.** In March 2021, Archegos, a family office,⁶ defaulted on its margin calls after taking large, concentrated, and leveraged positions in a small number of shares of US and Chinese technology equities through total return equity swaps. The total return swaps were entered with multiple banks, each of which was unaware of the firm’s large positions with the other banks. Some of these banks – particularly Credit Suisse, which suffered the largest losses – failed to rein in Archego’s risk-taking, ignored its persistent limit breaches and had insufficiently collateralised their swap positions with Archegos.⁷
- 4. The BCBS had two objectives when it finalised its large exposures (LEX) standard in 2014.⁸** The first was to complement the BCBS’s risk-based capital standard, which “is not sufficient to fully mitigate the microprudential risk from exposures that are large compared with a bank’s capital resources”. This is because the risk-based capital standard does not consider any form of concentration risk when

² The saying was coined in 1605 by Miguel de Cervantes Saavedra, the Spanish author of the novel *Don Quixote*. It was reused as the title of an article published in the Bank of England’s Quarterly Bulletin in June 2020. The idea, then as now, is to avoid concentrating all efforts and/or resources in one area at the risk of losing everything.

³ See BCBS (2012). Since 1997, the BCBS has highlighted the importance of concentration risk and large exposure limits in its *Core principles for effective banking supervision*, with Principle 19 stating that “the supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties”.

⁴ BCBS (1991).

⁵ This was evidenced in March 2023, when, because of rising interest rates, funding concentrations in large uninsured sight deposits and asset concentrations on long-term fixed rate securities (government securities in particular) led to the demise of several mid-sized banks in the United States.

⁶ A family office is a privately held company that manages the assets of a wealthy individual or family. As a private investment vehicle, it is often more loosely regulated than public companies and not subject to the same disclosures.

⁷ Credit Suisse incurred \$5.5 billion in losses following the March 2021 default of Archegos. On the failure of Archegos and Credit Suisse’s shortcomings in managing its exposures to it, see Credit Suisse (2021).

⁸ The LEX standard applies to large international banks, as defined by each BCBS jurisdiction. It came into force in 2019.

calculating minimum capital requirements.⁹ The LEX standard is therefore designed so that the maximum loss a bank could incur if a single counterparty or group of connected counterparties were to fail would not endanger the bank's survival. The second was to help ensure the stability of the financial system by limiting the risk of contagion between global systemically important banks (G-SIBs).¹⁰

5. **The LEX standard has five main components.** First, a large exposure is defined as an exposure to a single counterparty or group of connected counterparties that constitutes a single risk and that is equal to or exceeds 10% of the bank's Tier 1 capital. Second, the standard applies to all internationally active banks¹¹ on a consolidated basis and at every tier of a banking group. Third, it applies to all bank's assets and off-balance sheet items through which it has a claim on a counterparty, except for claims against sovereigns. Fourth, all large exposures or the bank's 20 largest exposures (whichever is the greatest) must be reported to the regulator both before and after considering credit risk mitigation (CRM) techniques. The fifth component is the concentration limits that a bank should not exceed.

6. **This paper identifies and discusses the main supervisory challenges associated with the implementation of the LEX standard and, more broadly, with the oversight of large exposures.** The implementation of this standard is conditioned by the supervisor's ability to conduct case by case assessments and make use of supervisory judgment and discretionary powers. As discussed, a case-by-case approach in assessing whether exposures are connected or not, whether exposures fall within the scope of the standard or constitute exceptions that warrant specific treatments or exemptions, whether and to what extent exposures are mitigated, and how to treat breaches of LEX limits depending upon their circumstances is essential to the enforcement of this standard. To address and overcome these challenges, supervisory authorities have developed a range of supervisory practices. To discuss these practices, the paper largely relies upon interviews conducted with 10 supervisory authorities.¹² Publicly available information such as supervisory manuals, guidelines and reports were also used as inputs.

7. **The scope of this paper is limited to the LEX standard as it does not aim to cover all forms of risk concentration.** More specifically, the paper focuses on default risk arising from concentrated exposures on a counterparty or group of counterparties, which is the only type of risk concentration that the standard covers. There are many other types of risk concentration, including geographical and sectoral concentrations and narrow business models that focus upon niches. These are addressed through Pillar 2 of the Basel Framework.¹³

⁹ In the Basel Framework, minimum capital requirements are determined on the assumption that credit portfolios are fully diversified.

¹⁰ G-SIBs are banks whose systemic importance has been assessed through an indicator-based measurement approach. The selected indicators reflect the different aspects (ie size, interconnectedness, complexity, lack of substitutability, global scope) of what makes a bank critical for the stability of the financial system.

¹¹ As with all other BCBS standards, member jurisdictions have the option to set more stringent standards. They also have the option to extend the application to a wider range of banks, with the possibility – if they deem it necessary – to develop a different approach for banks that usually fall outside the scope of the Basel Framework. See BCBS (2019a) and, for examples of jurisdictions that apply the LEX standard to a wider range of banks, BCBS (2019b), (2019e), (2022a) and (2023b).

¹² The interviews were conducted between November 2022 and January 2023. The authorities interviewed were: the Bank of England's (BoE) Prudential Regulation Authority (PRA), the Financial Services Agency of Japan (JFSA), the Single Supervisory Mechanism (SSM) of the European Central Bank, the European Banking Authority (EBA), the Prudential Authority (PA) of the South African Reserve Bank (SARB), the Financial Regulator of Kazakhstan, the Polish Financial Supervision Authority (KNF), the French Prudential Supervision and Resolution Authority (ACPR), the Board of Governors of the Federal Reserve (FRB) and the Office of the Comptroller of the Currency (OCC) in the United States.

¹³ On the asset side, these include exposures to common risk factors such as real estate prices or geographical regions. Risk concentrations may also lead to interest rate or foreign exchange risks and liquidity and funding risks. Concentrations may vary across jurisdictions, with some banks having risk concentrations because the economies in which they operate are not diversified. On the liabilities side, funding concentrations may reflect dependencies on a single type of funding or depositor or funding imbalances such as an over-reliance on short-term volatile funding sources. These concentrations are mostly addressed under Pillar 2, through specific treatments or on a bank-specific basis through the supervisory review process (SRP).

8. **The remainder of this paper is structured as follows.** Section 2 summarises the main features of the LEX standard and the challenges related to its implementation. Section 3 outlines the regulatory definition and criteria for connected counterparties and presents the challenges and the supervisory practices for identifying connected counterparties. Section 4 presents the supervisory approaches to address specific types of large exposures within the LEX framework, while Section 5 highlights eligible CRM techniques and the supervisory challenges related to verifying their effectiveness. Section 6 presents the main practices and associated challenges related to the supervisory reporting and monitoring of large exposures while Section 7 discusses the distinctions between types of breaches and the corresponding corrective measures that can be taken. Section 8 concludes with observations and considerations.

Section 2 – Main features and challenges associated with the LEX standard

9. **To determine whether an exposure is large, the LEX standard requires the aggregation of all exposures to a single counterparty or group of connected counterparties.** All exposures against a group of connected counterparties must be aggregated and considered as a single risk when they are interconnected either by a control relationship or by economic dependency. Two exposures need to be considered as a single risk when one counterpart has control, whether directly or indirectly, and generally through ownership, over the other.¹⁴ There can also be a need to aggregate exposures to two (or more) counterparts and consider them as a single risk when these have economic interdependencies.¹⁵ In both cases, determining whether counterparties should be connected or not constitutes one of the key implementation issues for banks and one of the key supervisory challenges for supervisors (see discussion in Section 3).

10. **Exposures taken into consideration include all assets and off-balance sheet items through which a bank has a claim against a physical or moral person except for claims against sovereigns.** In terms of instruments, this includes all loans and guarantees but also all securities that are not required to be directly deducted from a bank's regulatory capital.¹⁶ In terms of risk categories, the scope of exposures includes credit risk, counterparty credit risk and market risk positions. Finally, the exposures being considered are those against private sector agents or public sector entities (PSEs) that are not treated as sovereigns¹⁷ and are not guaranteed by it.

11. **The LEX standard applies on a fully consolidated basis and at every tier within a banking group.** This level of application acts as a backstop to the risk-based capital requirements. It is designed to ensure that large exposures do not exceed a certain proportion of the bank's capital and that this capital is adequately distributed among the banking group's legal entities.¹⁸ In particular, the application on a

¹⁴ The rationale for the control criterion is that should the controlling entity run into financial difficulties, it is very likely to use its control to extract capital and/or liquidity from its subsidiary, therefore weakening it to address its own problems.

¹⁵ The rationale for the economic interdependency criterion is that the financial problems of one counterparty are likely to cause financial difficulties for the other(s) to the extent that those counterparties are particularly linked, therefore compromising the repayment ability of their obligations.

¹⁶ The risk-based capital standards require that the value of equity investments in other banks and financial entities be deducted from a bank's regulatory capital. To the extent that the value of the exposure against a counterpart is the maximum loss that a bank may sustain and that it is fully covered, constraining the size of the exposure through a limit becomes unnecessary.

¹⁷ See BCBS (2023d).

¹⁸ Adequately distributed essentially means that all the group's entities need to be capitalised according to the exposures that they are holding. Sufficient capital is therefore required at the highest level of consolidation and at every tier within the banking group, including on a standalone basis. For an illustration of consolidation perimeters, see paragraph SCO 10.5 of the Basel Framework and the diagram illustrating the scope of the LEX standard.

fully consolidated basis is prescribed to ensure that a holding company that is the parent entity of a banking group is included in the consolidation.

12. **All large exposures equal to or exceeding 10% of the bank's Tier 1 capital or the 20 largest exposures of the bank must be reported periodically to the authority.** The LEX standard uses Tier 1 capital only because, unlike Tier 2 capital, it is available to absorb losses on a "going-concern basis"¹⁹ and is therefore more appropriate. Banks must report the accounting value of the exposure net of specific provisions and value adjustments.²⁰ All large exposures meeting this threshold and at least the bank's 20 largest exposures (even if below the 10% threshold) must be reported to the supervisory authority.

13. **Large exposures must be reported gross and net.** They must be reported before application of CRM techniques and after these techniques have reduced the value at risk of the exposures. To ensure that the exposure that is at risk is adequately reported, the supervisory authority needs to assess the eligibility and effectiveness of these credit risk mitigants in reducing the bank's loss should the counterparty fail.

14. **The standard limits large exposures to 25% of the reporting entity's Tier 1 capital.** The limit is reduced to 15% for large exposures held between G-SIBs to limit systemic risk.²¹ Verifying that limits are complied with, based on each bank's regulatory reporting, allows cases where they may be breached to be addressed.

15. **There are several supervisory challenges associated with the supervision of the LEX standard, with the first set relating to the identification and assessment of connected counterparties.** The LEX standard defines interconnectedness and two sets of criteria for assessing whether the controlling relationships or the economic interdependencies between two counterparties allow exposures to these two counterparts to be considered as constituting a single risk. However, the criteria are subject to interpretation, may not be comprehensive and do not necessarily imply the existence of a single risk in all cases.

16. **A second set of challenges is the need for specific approaches for certain types of exposures.** Various approaches specific to certain exposures exist under the LEX standard, such as the valuation of certain exposures and certain exceptions to the general treatment. The latter could be either general or jurisdiction specific. In addition, approaches need to be designed to address specific challenges. Examples of specific treatments under the LEX standard include the valuation of trading book positions. Exceptions include entities connected with sovereigns or intraday bank exposures. Examples of jurisdiction-specific exemptions which may be granted on a temporary basis relate to intra-banking group exposures or to supervisory exemptions granted in special situations such as mergers and acquisitions. Related party lending, where counterparties are connected to the bank,²² is a special, often opaque, and potentially risky type of interconnectedness that is subject to specific treatments in many jurisdictions, especially since it is not explicitly captured under the LEX standard.

¹⁹ Using total regulatory capital to define a large exposure leads to including Tier 2 capital (mainly in the form of subordinated debt instruments), although such capital is only available to absorb losses when the bank is no longer viable.

²⁰ As an alternative, a bank may be required to report the exposure value gross of specific provisions and value adjustments with additional columns detailing these provisions and adjustments. Some authorities prefer this more extensive reporting on the grounds that it also allows the adequacy of provisions and accounting adjustments to be verified.

²¹ Although most jurisdictions treat exposures to physical persons and to moral persons in the same way and subject them to the same limit, as does the LEX standard, some jurisdictions apply a separate and more stringent limit for exposures to physical persons and individual entrepreneurs, on the grounds that they are riskier. For example, the Saudi Arabian Monetary Authority's large exposures rule states that "the sum of all the exposures values a bank has to an individual or a sole proprietorship or a partnership must not be higher than 5 per cent of the bank's available eligible capital base at all times" (SAMA (2019)).

²² Parties related to the bank typically include its shareholders, the bank's senior management, members of their families and the firms they may control.

17. **A third set of challenges relate to CRM techniques.** The LEX standard and jurisdictional regulations that translate it into domestic law contain multiple requirements and conditions that need to be met for CRM techniques to be eligible. When these conditions are met, the value of the mitigant can be used to reduce the bank's gross exposure. In practice, however, case by case assessments are needed to assess and verify the reality and the effectiveness of each eligible CRM instrument, and to ensure that the protection provided is valued conservatively.

18. **A final set of challenges relates to the treatment of breaches, the supervisory measures taken to address them and the return to compliance.** While the LEX limits are not supposed to be breached, this can nevertheless happen. The corrective measures that will allow the bank to return to compliance need to be selected and included in the bank's remediation plan. Another important component is the timeline for addressing breaches. While breaches should be addressed as soon as possible, the time needed to return to compliance may vary significantly depending on their nature and severity. In practice, such a time frame is determined on a case-by-case basis and includes a strong element of supervisory discretion.

Section 3 – The challenges of identifying connected counterparties

Regulatory definition and assessment criteria for connected counterparties

19. **The standard generates the presumption that exposures to connected counterparties must be aggregated because they constitute a single risk.** The LEX standard defines a group of connected counterparties as those that have "specific relationships or dependencies such that, where one of the counterparties should fail, all of the counterparties should very likely fail". The standard specifically requires that such a group of connected counterparties "must be treated as a single counterparty" with "the sum of the bank's exposures to all of the individual entities included within a group of connected counterparties" being "subject to the large exposure limit and to the regulatory reporting requirements".²³

20. **Banks must identify connected counterparties based on two sets of criteria.** The first set is the existence of a control relationship where two or more natural or legal persons are deemed to constitute a group of connected counterparties if one of the counterparties, directly or indirectly, has control over the other(s). The second set relates to economic interdependence such that should one of the counterparties experience financial difficulties, in particular funding or repayment difficulties, the other(s) would also be likely to encounter funding or repayment difficulties.²⁴

21. **When one entity owns the absolute majority of voting rights of one or several other entities, banks must automatically consider that there is a control relationship.** This is because when one entity owns more than 50% of the voting rights of the other, it has the legal power to extract resources (in terms of capital and/or funding) from the controlled entity should the controlling entity experience financial difficulties. The size of this risk is the aggregated exposure to the controlling entity and to all controlled entities. The standard also includes three sets of additional criteria that constitute rebuttable presumptions of control. These are voting agreements, significant influence on the appointment or dismissal of the majority of members of an entity's administrative, management or supervisory body, and significant influence on senior management, with the ability to exercise a controlling influence over the

²³ See paragraph 10.9 of the LEX standard under LEX10 – Definitions and application.

²⁴ Under LEX10, see paragraph 10.10 of the LEX standard for the definitions of control relationship and economic interdependence and paragraph 10.11 for the requirement for banks to assess the relationship among counterparties to establish the existence of a group of connected counterparties.

management or policies of another entity.²⁵ Voting agreements are cases where the control of a majority of voting rights is obtained through an agreement with other shareholders. In addition, banks are expected to consider criteria and qualitative guidance specified in the relevant international accounting standards to determine control.²⁶

22. **Banks also need to establish whether two or more entities are connected based on one or several economic interdependencies.** The standard lists seven qualitative criteria of economic interdependencies (see Box 1) that banks need to consider, at a minimum. These are expected to cover cases of interdependencies, including contractual outsourcing relationships, franchises and/or cases where one counterparty guarantees the exposure of the other. Also included are cases where both counterparties rely on the same expected sources of funds to repay their loans and have no other independent source of income.

23. **Establishing control and/or economic dependency between two or more counterparties is case-specific and complex.**²⁷ The standard recognises that there can be exceptional cases in which a bank can demonstrate that, due to specific circumstances, the control or economic dependency criteria are not sufficient to establish that the exposures constitute a single risk. For the control criteria, cases include corporate governance safeguards and arrangements²⁸ where the difficulties or even the demise of the controlling entity would not necessarily lead to similar difficulties at the other entity. The economic dependence criteria may also be overcome if the bank can demonstrate that the counterparty which is economically related to another would be able to withstand financial difficulties at the latter entity, for instance by sourcing alternative funding in a timely manner without bearing excessive costs.

24. **When the exposure to a counterparty exceeds 5% of the bank's Tier 1 capital, the LEX standard requires banks to assess economic interdependence.** This is because while an exposure may not meet the large exposure definition on its own, it may nevertheless need aggregating with many others to the extent that, together, they constitute a large exposure.

²⁵ In practice, a controlling influence may be exercised either through consent rights or through the ability to veto key decisions.

²⁶ See BCBS (2023a), and in particular paragraph 10.14 of the LEX standard under LEX 10 – Definitions and application.

²⁷ See BCBS (2019d). Largely because of this complexity, some jurisdictions introduced transition periods when implementing the LEX standard. For instance, Australia introduced a one-year transition period when implementing its rules for groups of connected counterparties.

²⁸ These can include certain arrangements in which one entity is bankruptcy remote, with its assets and revenues being independently managed and placed beyond the reach of the other.

LEX standard: connectedness based on economic interdependence

The seven qualitative criteria

The LEX standard contains seven qualitative criteria that banks must consider when seeking to establish economic interdependence. Each criterion, if met, constitutes an assumption of interconnectedness, meaning that the bank needs to establish that; (i) the criterion (criteria) is (are) met; and (ii) it is (they are) sufficient to establish interconnectedness between the two or more counterparties. These criteria are the following:

- Where 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (eg the owner of a residential/commercial property and the tenant who pays a significant part of the rent).
- Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs.
- Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers.
- When the expected source of funds to repay the loans of both counterparties is the same and neither counterparty has another independent source of income from which the loan may be serviced and fully repaid.
- Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities.
- Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s).
- When two or more counterparties rely on the same source for most of their funding and, in the event of the common provider's default, an alternative provider cannot be found – in this case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source.

The LEX standard recognises that these criteria must be considered "at a minimum", with banks expected to consider other criteria as needed. Supervisors may also request that reporting institutions do so through supervisory guidance. Moreover, the standard also makes it clear that the economic dependence criteria are qualitative in nature, that they do not automatically imply interconnectedness and that the assumption that they create can be overcome.

Challenges in identifying connected counterparties

25. **Establishing whether two or more counterparties are interconnected and constitute a single risk is challenging and requires a comprehensive analysis.** When seeking to establish that there is no interconnectedness, the burden of proof is on the institution. It needs to demonstrate to its supervisor, on a case-by-case basis, that specific circumstances allow the counterparties to be considered not (or not sufficiently) interconnected to be viewed as a single risk. However, the supervisor needs to determine whether and to what extent the bank's case is sufficiently convincing to justify such a treatment.

26. **A second challenge is that the definition of interconnectedness and the sets of criteria for assessing it leave room for interpretation.** Different interpretations are both necessary and required by the standard since establishing the existence of interconnectedness must be based on the circumstances of each case. Consequently, the standard cannot (and, by design, does not) provide a unique definition of interconnectedness that is automatically and identically applicable across all jurisdictions, all banks, and all cases. Instead, it provides a general definition and sets of minimum criteria that each supervisory

authority must interpret, adapt, and complete to address the cases encountered in its jurisdiction. While flexibility and ad hoc solutions are necessary because interconnectedness needs to be tailored to each case, this can also lead to diverging supervisory practices across jurisdictions.

27. **A third challenge relates to differences in banks' risk management frameworks.** Policies, internal rules and risk aggregation criteria and practices vary significantly from bank to bank and may lead to different outcomes. For example, some of the authorities interviewed mentioned specific cases where the same counterparties would be considered as interconnected for one bank but not interconnected for others.

28. **A fourth challenge is that the supervisor's ability to verify the interconnectedness of exposures and the bank's aggregation choices is limited.** By design, the oversight of large exposures is based on the bank's choices and the information it provides to the supervisor to support them. While the bank needs to report all exposures which, when aggregated as part of a single risk through interconnectedness, would exceed 10% of its Tier 1 capital, it is difficult for a supervisor to systematically verify how accurately and comprehensively this has been done. This is because the bank will have aggregated large numbers of individual exposures through its risk management framework. There may also be cases where interconnectedness is minimised, under-reported or partly hidden, whether deliberately or not.

29. **Difficulties to challenge a bank's exposure aggregation choices are magnified by the need to add indirect exposures and potential exposures to direct exposures.** Those arise eg from CRM techniques and from commitments to lend.²⁹ Unless the bank is required to provide reconciliations, it is at best difficult for the supervisory authority to verify all aggregations on its own.³⁰ While supervisory verifications do take place, both during on-site examinations and as part of off-site reviews, it is rarely possible to systematically, comprehensively and frequently review all of a bank's large exposures, especially for sizeable institutions.³¹

Addressing supervisory challenges when assessing interconnectedness

30. **To overcome challenges and complexities in identifying and assessing interconnectedness, regulators use guidelines and case by case approaches to assess exceptions.** The guidelines typically aim to ensure consistent treatments across banks. They may leverage good practices, draw on concrete cases and provide additional interconnectedness criteria.

31. **The EBA's guidelines and Regulatory Technical Standards (RTS) on the identification of a group of connected clients is one of the most elaborate and comprehensive frameworks for assessing interconnectedness.**³² Both the guidelines and the RTS largely draw on supervisory practices since the LEX standard was translated and implemented in the European Union providing additional clarifications regarding the control criteria and the economic dependency criteria. A first guideline was issued in 2017. The RTS consists in a revised and updated version of the guidelines, which, being a delegated act, is inherently more prescriptive and stricter than guidelines (see Box 2).

²⁹ See BCBS (2023a). As specified under the LEX standard (paragraph 30.6), off-balance sheet items will be converted into credit exposure equivalents using credit conversion factors (CCFs) by applying the CCFs set out for the standardised approach for credit risk for risk-based capital requirements, with a floor of 10%.

³⁰ Part of the difficulty is that indirect exposures are not reported when they are below the reporting threshold. Accordingly, and unless the supervisory authority explicitly requires the bank to do so, the supervisor cannot, on its own, fully reconcile indirect exposures and guarantees/collaterals at an aggregated level.

³¹ In practice, most of the authorities interviewed highlighted their limited capacity to challenge a bank's decisions when establishing whether exposures are interconnected.

³² See EBA (2017, 2022). These guidelines and RTS are elaborated based on Regulation (EU) 1187/2014 of the European Commission (delegated act).

The EBA's Regulatory Technical Standards (RTS) on groups of connected clients

The latest version of the EBA's RTS clarifies several aspects of the control relationship definition, including the following:

- The guidance addresses explicit cases where two (or more) legal persons are subsidiaries of the same parent entity while not having any relationship with each other. Such situations arise in cases in which a bank may have exposures to subsidiaries but not to the parent entity that controls the group. The guidance establishes that when the subsidiaries "are part of the same consolidated financial statements", and therefore controlled by the same natural and/or legal person, they are still deemed to be interconnected by a control relationship. The supervisory authority therefore still needs to assess whether and to what extent such a relationship leads to the exposures being considered as a single risk.
- Another clarification relates to cases where a parent entity may control several entities and publishes consolidated statements that include all of them but where these entities constitute special purpose entities (SPEs) with bankruptcy remote arrangements. In such cases, the assumption of a single risk may be rebutted despite the existence of a control relationship.^①

The EBA's RTS also provides guidance on establishing interconnectedness based on economic dependency. The reason for this extensive guidance is that the purpose of assessing economic interconnections is "to identify channels of contagion stemming from economic dependencies that a natural or legal person cannot overcome without experiencing repayment difficulties". The RTS has provided guidance in several ways:

- The first has been to expand the number or the scope of the minimum qualitative criteria to consider. While the LEX standard lists seven minimum criteria (Box 1), the RTS has 11. For instance, one of the additional qualitative criteria is to assess economic interdependence "where a significant part of the receivables or liabilities of a natural or legal person is to another natural or legal person".
- The second way has been to add components to the standard's existing minimum criteria. For instance, this was done to better capture the extent to which funding or repayment difficulties at one counterparty could create financial problems for the other entity(ies).^②
- A third way has been to present multiple scenarios of control relationships or economic dependency and the respective analyses leading (or not) to the grouping of exposures from connected counterparties.

Finally, the RTS clarifies how control relationship and economic dependency criteria may be interrelated and combined for a given group of connected counterparties. The control and economic dependency criteria are two types of interconnectedness that the LEX standard requires be assessed separately. However, they do not necessarily constitute separate alternatives in all cases, nor do they automatically lead to mutually exclusive groups of interconnected counterparties. A control relationship which establishes the legal dependency of the subsidiaries towards a parent entity "is also a manifestation of economic dependency". More generally, the fact that both kinds of interconnectedness may exist within a group leads to assessing both downstream contagion effects (from the parent to the subsidiaries) and upstream contagion effects (from the subsidiaries to the parent), even though the LEX standard does not explicitly require this.

^① Demonstrating that the exposures do not constitute a single risk requires assessing: (i) the absence of economic interdependence between the SPE and the parent entity; (ii) the SPE's bankruptcy remoteness arrangements; (iii) the structural enhancements in a securitisation such as the existence of provisions in the transaction's documentation that ensure servicing, operational continuity and the de-linkage of the SPE's obligations from those of its parent undertaking; and (iv) that the relationship is at arm's length, ie not structured in ways where the parent entity would be obligated to support the SPE. ^② The LEX minimum qualitative criterion assumes economic dependency "where 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty", while the RTS criterion mentions that "a significant part" of the gross receipts or gross expenditure must be derived from these transactions while explicitly adding the condition that it "cannot be replaced in a timely manner without excessively increased costs".

32. **A well-structured case by case approach is commonly used by supervisors to assess interconnections.** Such an approach provides flexibility and discretion for the reporting institution and the supervisory authority since each case is specific. For the reporting institution, the advantages reside in its ability to present applications for having counterparties excluded from groups of connected counterparties and to tailor the rationales and select the documentation provided for obtaining such exemptions. For the supervisor, discretion comes into play when determining what additional information may be needed to reach a decision. There is also discretion regarding the request's examination and how a decision may be reached. Finally, flexibility and discretion also extend to the time required for assessing applications as there is no pre-determined time frame for reaching a decision.³³ In practice, case by case approaches involve common steps.

33. **The first step concerns the contents of the bank's application.** There are no requirements in the standard regarding the form, the substance or the information needed to support the application.³⁴ While this provides flexibility for the reporting institution, since it can select the supporting information that it deems helpful, it also implies that the burden of proof lies with the bank.

34. **The second step involves the supervisory authority's analysis of the case.** This typically starts with reviewing the information provided by the bank and obtaining additional information to augment the review and assessment of the application. The information may be requested from the bank or obtained from any other source. Assuming it has not already been provided, one type of information that the supervisory authority needs to procure when reviewing interconnectedness is the group's structure and organisation charts and any financial information related to it. An analysis of the periodic (quarterly) regulatory data reported by the bank on its large exposures also needs to be conducted and compared with the information received as part of the reporting institution's application.

35. **The third step initiates the dialogue with the bank.** The supervisor's purpose is to understand the application's rationale and obtain clarifications. The objective of this engagement is to: (i) challenge the reporting institution on its assessment; (ii) understand the internal governance process followed; (iii) gain insights from other relevant factors that the bank may raise; and (iv) allow the institution to demonstrate in practice (via its risk management system) how it has identified and assessed interconnections, and why these may warrant an exceptional treatment. After such discussions, follow-up questions or requests for additional information are also typical. These will, in turn, be analysed and lead to further meetings with the bank providing additional explanations.

36. **The fourth step covers the decision-making phase.** This begins with presenting the case, the evidence compiled by the supervisory authority, the staff's own analysis and the recommended decision. While practices vary across jurisdictions, decisions are typically taken at senior levels of the supervisory authority, often by a panel, committee, or commission.³⁵ An important consideration is the bank's right to a fair hearing. In several jurisdictions, this includes the right for the bank to present its case to the decision-making body and/or be legally represented when the case is heard.

37. **The fifth step involves formally notifying the bank.** This is generally done through a formal feedback letter. If the application is approved, the letter needs to include the period for which the approval is granted and state the reasons for granting it. Should the application be declined, the reasons for this

³³ In practice, the absence of a predetermined time frame for examining an application allows the supervisor to tailor the examination to the specifics of the case. Some cases may be straightforward and solved in a few weeks, whereas others may be complex. In more complex cases, additional information, and in-depth investigations, including on-site examinations, are often required. However, the absence of a time frame also implies that decisions may not always be taken or may be untimely.

³⁴ The bank is free to provide any documentation it believes to be helpful in supporting its case. However, the fact that the bank can tailor documentation allows it to be selective in the information that it chooses to provide, potentially allowing it to provide selective, biased and/or incomplete information.

³⁵ For instance, at the PA of the SARB, the case with the accompanying evidence and analysis by supervisory staff is presented to a risk committee that includes the PA's senior management.

must be explained so that the decision becomes legally opposable and can be appealed against. In practice, most applications granted are subject to conditions, time limits and milestones providing for regular regulatory updates. For instance, the exception granted may need to be renewed yearly and would be subject to reassessment. It may also be subject to controls, such as regular reviews from the bank's internal and external auditors and/or on-site supervisory examinations to ensure that the circumstances that led to the exemption remain unchanged.

38. Finally, there may be a sixth step should the bank appeal against the supervisory decision.

The modalities of the right to appeal vary across jurisdictions. However, at a minimum, they include the right to challenge the supervisory decision, possibly through legal proceedings. Prior to reaching such a stage, some supervisory authorities also allow the bank to appeal the decision to a specialised administrative body within the supervisory authority. The procedures to be followed are generally those established for challenging any of the supervisory authority's decisions.³⁶ In practice, appeals and legal actions regarding decisions concerning large exposures regulations are relatively rare.

Section 4 – Approaches for specific types of exposures

Approach to intragroup exposures

39. Intragroup exposures are not part of the international LEX standard's scope. Generally, banking groups, affiliates, federations of cooperatives, mutual and/or savings associations use intragroup transactions to facilitate the movement of funds and benefit from synergies, cost savings and capital efficiencies within their respective financial structures. Despite these exposures not being part of the LEX standard's scope, many jurisdictions consider them as a source of significant concentration risk due to inherent interconnectedness.

40. Several authorities distinguish between two categories of intragroup exposures. The first includes intragroup exposures that are accounted for at a consolidated level. Under the standardised approach for credit risk, these exposures receive a risk weight of 0%. Under the LEX standard, most of the authorities interviewed³⁷ do not apply the LEX limit to these exposures. Instead, these transactions are unlimited, allowing banks to benefit from the operational efficiencies of being part of a banking group. The second type includes exposures that are not accounted for at a consolidated level and where the LEX limit applies.

41. When applying the interconnectedness criteria to intragroup exposures that are not consolidated, there are two sets of practices. One set considers each of these intragroup exposures as being separately subject to the LEX limit, meaning that the intragroup exposures are not aggregated because they are not considered to be a single risk. This is, for instance, the practice chosen by the PA in South Africa.³⁸ Under the other set of practices, used for instance in the European Union, these exposures will be considered as part of the group of connected counterparties if the entity is connected through a control relationship or meets any of the economic interdependence criteria.³⁹

³⁶ As for any administrative decision that can be appealed, the supervisory decision must be explicitly notified to the bank and explained in writing. Failure to notify in writing or to explicitly provide a motivation for the decision typically leads to its invalidation.

³⁷ These include EU authorities (the EBA, France's ACPR and Poland's KNF), the PA in South Africa and the UK's PRA. A similar practice is used in other jurisdictions including Canada, Hong Kong SAR, and Australia. See, for instance, Polish Financial Supervision Authority (2016).

³⁸ See Prudential Authority of South Africa (2022a), paragraph 7.5 p 8.

³⁹ See EBA (2018).

42. **Certain jurisdictions limit the size of cross-border intragroup exposures.** In the United Kingdom, for instance,⁴⁰ the treatment of intragroup exposures has evolved since the Great Financial Crisis (GFC). To limit contagion should one entity in the group experience stress, in 2010 the UK regulator introduced a cross-border limit of 100% of total eligible capital.⁴¹ Although UK rules have been refined with the introduction of the international LEX framework, this limit remains in place. Essentially, a bank in the UK can exempt certain cross-border intragroup exposures that are included in a non-core large exposures group permission, provided that these exposures do not exceed 100% of the bank's Tier 1 capital. Exposures to intragroup entities that are not subject to an intragroup permission are treated as exposures to a third party and are therefore subject to the 25% LEX limit. The purpose of such a measure is to reduce concentration risks within a banking group that has exposures outside the national borders of the UK.

43. **In some cases, rules for intragroup exposures are covered in separate legal frameworks.** For example, in the United States, the rules for transactions with affiliates are issued under the authority of the Federal Reserve Act.⁴² This implies that the scope of applicability is extended to all banks or institutions that form part of the Federal Reserve System. In addition, all other US insured depository institutions are also subject to these requirements through other statutes.⁴³ The limit placed on the maximum exposure a bank can have to a single affiliate⁴⁴ is limited to 10% of the bank's total capital⁴⁵. Further, the aggregated exposure to all the bank's affiliates is limited to 20% of the bank's total capital. Notwithstanding certain criteria and exemptions that may apply to these transactions, the respondent banks must demonstrate their compliance with these rules by completing a quarterly regulatory template.⁴⁶

44. **Where intragroup exposures are limited, temporary exemptions from these limits may be granted on a case-by-case basis.** The purpose of such exemptions, which are typically granted in a bank resolution context, is to remove a regulatory barrier obstructing the efficient and timely resolution of the failing institution. For example, the Japanese Financial Services Agency (JFSA) states in its regulation that LEX limits do not apply when a distressed financial institution has to be resolved through a merger and acquisition procedure based on the Deposit Insurance Act. However, these exemptions also rely upon an application procedure: they are granted only if demanded, on a case-by-case basis, instead of being automatically extended. Such an approach provides the supervisory authority with full discretion to consider the specificities of each scenario and determine the time frame for which the exemption may apply.

⁴⁰ See BoE PRA (2020).

⁴¹ See Financial Services Authority (2010).

⁴² See Board of Governors of the Federal Reserve (2002), 12 USC 371c and 371c-1.

⁴³ See *ibid*, 12 USC § 1468(a) and 1828(j). For example, 12 USC 1468(a) applies Section 23A and 23B of the Federal Reserve Act to savings associations.

⁴⁴ See *ibid*, 12 USC 371c(a)(1)(A).

⁴⁵ Capital stock and surplus are defined in FRB Regulation W, 12 CFR part 223.

⁴⁶ See Board of Governors of the Federal Reserve (1933a) - Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates.

Related-party lending (RPL) – a grey area?

45. **BCBS guidance underscores the need for banks to have adequate internal policies and procedures regarding transactions with related parties.** The Basel Core Principles (BCP) define related-party transactions⁴⁷ and highlight minimum criteria⁴⁸ for sound supervisory practices such as monitoring the exposures, taking appropriate steps to control or mitigate the risks that arise, assessing that transactions are entered on an arm's length basis and ensuring that banks write off such exposures according to standard policies and procedures.⁴⁹

46. **The LEX standard does not capture RPL explicitly.** By design, the standard is binary. It considers that exposures are either interconnected or not and, accordingly, they are aggregated and considered as a single risk or considered as separate risks and subjected separately to the LEX limit. Moreover, the LEX standard is designed to capture interconnectedness between a bank's counterparties. It does not assess whether a large exposure may also be an exposure to a related party and does not consider the complex relationships between the bank, its affiliates, its shareholders, senior management, board members and the entities or individuals related to them. Such relationships, which are generally opaque, may be problematic for supervision. Exposures to related parties should normally be subject to the standard requirements to the extent that they constitute large exposures. However, some jurisdictions could treat them as intragroup exposures and exempt them from these requirements.

47. **Many authorities consider that RPL lending is a specific and particularly risky type of exposure that requires a more stringent regime.** The beneficiaries of such lending are typically in some sort of conflict of interest situation, to the extent that such situations have even been termed "insider lending" in US regulation.⁵⁰ While lending to such beneficiaries is not necessarily illegitimate, they are in a position to influence in their favour the bank's decision to lend and the associated terms and conditions. Moreover, RPL lending may often be opaque. It may be neither reported to the regulator nor publicly disclosed and may also bypass normal governance arrangements and credit granting procedures. Finally, RPL lending may be used to disguise the bank's real financial position by inflating its reporting and disclosed capital. This is particularly the case when shareholders benefit from related party loans to fund their stakes in the lending bank, because such "capital" may not be loss-absorbing. Accordingly, many authorities have in place a specific regime for exposures to "related parties" (RPs). Such regimes are often more stringent than the large exposures regime, to reflect the higher risk that RPL entails.

48. **The implementation of the LEX standard has generated challenges for authorities as the new standard and the pre-existing RPL requirements needed to be combined.** Implementing and maintaining two "parallel" frameworks – one for LEX and one for RPL – increases the complexity of supervisory oversight. This is reinforced by the fact that both frameworks are self-declarative. An additional

⁴⁷ See BCBS (2012). According to Basel Core Principle 20, "Related parties can include, among other things, the bank's subsidiaries, affiliates, and any party (including their subsidiaries, affiliates and special purpose entities) that the bank exerts control over or that exerts control over the bank, the bank's major shareholders, Board members, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies".

⁴⁸ See BCBS (2000, 2012).

⁴⁹ For an example of how these criteria have been implemented, see Bank of England – Prudential Regulation Authority (2014).

⁵⁰ See Board of Governors of the Federal Reserve (1994) (1933a) and (1975). In the United States, FRB Regulation O, 12 CFR part 215 includes a specific definition of an "insider" as being "an executive officer, a director, or a principal shareholder, and includes a related interest of such a person". A "related interest" is any company or political or campaign committee controlled by an insider. See 12 CFR 215.2(n). FRB Regulation W may also include as "affiliates" entities that are under common control with the insured depository institution, including entities controlled by controlling shareholders of the insured depository institution (see 12 USC 371(c)(b)(1); 12 CFR 223.2). In addition, the Federal Reserve Act Section 23 A restricts transactions between a bank and its affiliates. Section 5(c) of the Bank Holding Company Act US regulation also requires all bank holding companies to report to the Federal Reserve System transactions with affiliates for each insured depository institution.

issue that limits the integration of the two frameworks and their comparability across jurisdictions is the absence of international guidelines for RPL. As a result, national RPL requirements may differ considerably.

49. **In some jurisdictions, the implementation of the LEX standard led to a “migration” of RPL requirements from Pillar 1 to Pillars 2 and 3.** In France, for instance, Pillar 1 requirements that provided for the deduction of related party exposures from own funds calculation in certain cases were repealed when the European single rulebook entered into force in 2014. These requirements have mostly become Pillar 2 guidelines for supervisory assessments of concentration risks, of related party lending and of step-in risk, and specific reporting requirements under Pillar 3.⁵¹ Additional reporting requirements for exposures to counterparties that are deemed to be connected with the bank are also relatively frequent.⁵²

50. **In other jurisdictions, the two regimes co-exist despite their differences.** Some differences relate to their respective scope of application, ie whether they apply to all banks, to all internationally active banks or only to domestic systemically important banks (D-SIBs). Other differences relate to the maximum exposure limits set by the authorities, with the LEX standard being harmonised while RPL limits vary across jurisdictions. Other differences include the denominators used to determine the limits (either Tier 1 or total capital), the supervisory approach used (Pillar 1 or 2) and the form taken to cap the exposures.⁵³ Another difference is that some jurisdictions have specific criteria for identifying related parties. The related party criteria are generally specified in their legislation or in guidelines.⁵⁴

51. **In some jurisdictions, RPL exposures are subject to specific limits under Pillar 1.** Because RPL exposures can be riskier than other large exposures, there is a case for an RPL limit to be more stringent than the LEX limit when both frameworks coexist.⁵⁵ Some jurisdictions practice an additional cumulative limit that applies to all counterparties related with the bank. Although thresholds and methodologies differ across jurisdictions, quantitative limits established by relating a bank’s total exposure to all its related parties to its regulatory capital are often higher than the LEX limit.⁵⁶

52. **Some jurisdictions have gone one step further and established a maximum aggregated limit for all large exposures, including related party exposure.** Introducing a limit that applies to all of a bank’s aggregated large exposures is intended to prevent a bank from concentrating a large part of its

⁵¹ Prior to implementing the LEX standard in 2014, France had a national large exposure standard and RPL limits. The first was replaced by the LEX standard, which applies to all banks in the European Union. Regulating RPL became the purview of the EBA and is subject to national guidelines under the Supervisory Review and Evaluation Process (SREP). While there are no longer RPL limits in France, a regulation from the Ministry of Finance allows the supervisory authority to set requirements to ensure that related party transactions for banks, payment institutions and investment companies are subject to appropriate internal controls and to regulatory reporting.

⁵² In the US for example, Regulation O requires certain disclosures related to RPL. In particular, and upon receipt of a written request from the public, banks must disclose the names of insiders with extensions of credit that, in the aggregate, equal or exceed 5% of the bank’s capital and unimpaired surplus or \$500,000, whichever is less (see 12 CFR 215.9(b)(1)). No disclosure is required if the aggregate amount of all extensions of credit outstanding to the executive officer or the principal shareholder of the bank does not exceed \$25,000 (see 12 CFR 215.9(b)(2)). A bank must also report the aggregate amount of extensions of credit to all its insiders in the banking agencies’ Report of Condition and Income.

⁵³ The exposure limit may be determined as a percentage of regulatory capital, as an absolute size limit or as a threshold beyond which the excess exposure is deducted from the bank’s capital.

⁵⁴ For instance, in Kazakhstan, the supervisory authority (AIFC) uses a separate set of criteria to define counterparties related to the bank. Those are defined under Article 40 of the country’s Banking Law, “Counterparties having specific relationships with the bank”, and under Article 64 of the Law of Listed Companies under the term “Affiliated counterparties”.

⁵⁵ See National Bank of the Republic of Kazakhstan (2017) and Board Resolution of the Agency of the Republic of Kazakhstan for Regulation and Development of Financial Market (2021). While the Kazakhstan large exposures regime sets the limit at 25% of the bank’s regulatory capital, the maximum RPL limit in Kazakhstan is 10% of regulatory capital. Other countries that were previously part of the Soviet Union have set an RPL limit of 20% of regulatory capital, having the equivalent limit for “ordinary” large exposures set as 25%.

⁵⁶ For instance, Kazakhstan limits the aggregated exposure of a bank to all related counterparties to 100% of total capital. See National Bank of the Republic of Kazakhstan (2017) and Board Resolution of the Agency of the Republic of Kazakhstan for Regulation and Development of Financial Market (2021).

lending on a relatively small number of customers (often made up of large corporate customers).⁵⁷ This limit applies to all aggregated large exposures, including those that constitute cases of related party lending or not.

53. **Additional qualitative requirements are enforced through the reporting and monitoring of terms and conditions applied to RPL.** These include pricing, loan maturity, terms of reimbursement and collateral coverage. The purpose is to ensure that the loan obligations contracted by the related parties do not include preferential terms and conditions and that they are not used to conduct opaque “profit and loss transfers” between the bank and related parties. Such arm’s length requirements are typically enforced by supervisory authorities as part of the supervisory review process. However, they can also be subject to the regulation of other authorities, such as market conduct authorities, depending on the local institutional arrangements.

Interbank exposures

54. **One of the key changes introduced by the LEX standard is the removal of the blanket interbank exposure exemption.** Accordingly, interbank exposures with maturity exceeding a day are subject to the LEX limits, to prevent adverse consequences in the event of bank failure.⁵⁸ It is only during periods of market-wide stress that supervisors may have to accept a breach of the LEX limit to maintain stability in the interbank market.⁵⁹ As a consequence, supervisory authorities have adjusted their large exposure requirements applicable to interbank exposures in various ways to prevent disruptions in their respective domestic interbank markets.⁶⁰ Some authorities have retained flexibility or authoritative power,⁶¹ while others have exempted certain interbank exposures⁶² from their local implementation of the LEX standard.

55. **Some jurisdictions apply proportionality to smaller banks when considering limits on interbank exposures.** This type of approach considers, among other things, the diversification challenges that smaller banks experience when having to place funds across multiple banks for liquidity purposes. For this reason, in the UK, the Prudential Regulation Authority (PRA) has raised the LEX limit for interbank exposures of smaller banks with capital equal to or less than €600 million⁶³ to 100% of total eligible capital.

⁵⁷ In addition to the individual large exposures limit (defined as 25% of total capital), Kazakhstan sets a total limit for all large exposures at a maximum of 500% of total capital. South Africa has set its aggregated large exposure limit at 800% of Tier 1 capital and enforces the limit. The Saudi Arabian Monetary Authority requires that the sum of a bank’s large exposures must not exceed six times the bank’s eligible capital.

⁵⁸ However, intraday interbank exposures are not subject to the LEX limit (see BCBS (2023a)).

⁵⁹ See BCBS (2023a), paragraph 30.36.

⁶⁰ When exempting intraday interbank exposures, EU regulation also includes the following business day to account for time zone differences that may affect transactions beyond the institution’s control. The Monetary Authority of Singapore also exempts intraday exposures to a bank up to two business days from the date of the transaction, subject to specific reasons (MAS (2021), p 15).

⁶¹ Authorities such as Australia’s APRA and Japan’s JFSA have retained the power to grant banks an authorisation, in exceptional cases and prior to entering a transaction, allowing them to exceed the LEX limit. Although such cases are rare, these pre-approvals give banks flexibility to engage with their supervisory authorities proactively and transparently.

⁶² The Hong Kong Monetary Authority (HKMA) exempted interbank exposures that relate to the receiving bank in an initial public offering (IPO) transaction. Due to the common occurrence of oversubscription of IPOs together with the significant value of these transactions, the receiving monies are placed on the interbank market by the receiving bank to ensure and maintain sufficient market liquidity (see BCBS (2020a), from p 7).

⁶³ The LEX standard was designed for internationally active banks. Some jurisdictions that apply the standard to all banks in their respective jurisdictions (eg the EU) apply the limit irrespective of the bank’s size. Others (eg the US) have adopted a customised approach for banks that fall outside the scope of the Basel Framework.

In Japan, the JFSA uses the domestic definition of eligible capital for domestic banks as the denominator of the large exposure ratio.

56. **Several authorities also exempt interbank exposures within cooperative networks.** Several authorities in the European Union have adopted an approach that exempts interbank exposures to networks of cooperative banks and other similar structures from the large exposure limit.⁶⁴ In networks of cooperatives, the two main types of exposures that benefit from these exemptions are the equity holdings and the deposits of local cooperative banks in the network's central institution. Exposures to deposit guarantee schemes (DGS) of cooperative networks are also exempted, with a DGS being defined as a public scheme backed by government guarantees so that the exemption belongs to the category of special treatments for government exposures.

57. **A second category of exemptions relate to interbank exposures that promote specific sectors of the economy.**⁶⁵ For instance, EU regulations allow member state authorities to exempt from large exposures "exposures to credit institutions incurred by credit institutions, one of which operates on a non-competitive basis and provides or guarantees loans under legislative programmes or its statutes". The purpose of the loans or guarantees is to "promote specified sectors of the economy under some form of government oversight" and subject to restrictions on the use of the loans, provided that the respective exposures arising from such loans are passed on to the beneficiaries. Depending on jurisdictions and specific schemes, the exposures may be either fully or partially exempted.⁶⁶

58. **Transitional arrangements are applied to interbank exposures in some jurisdictions to prevent disruptions in smaller and/or concentrated domestic markets.** South Africa is one example where such tailoring was deemed necessary. Due to the concentration of South Africa's banking sector, the PA recognised the importance of placing a limit on exposures between banks, including those related to G-SIBs and D-SIBs, while also seeking to alleviate the consequences of imposing the limit fully and immediately (see Box 3). Accordingly, the PA introduced transitional arrangements and higher but temporary limits that are tightened over time to support a smooth transition over a period of three years from April 2022 to January 2025.

⁶⁴ Austria, Spain, France, Hungary, Luxembourg, the Netherlands, Poland, and Portugal fully apply this exemption. Germany and Poland apply the exemption partially. In Germany, only 50% of participations and holding are exempted (EBA (2016), p 20).

⁶⁵ See EBA (2013b). The exemptions, including interbank exposures and those that promote specific sectors of the economy (such as small and medium-sized enterprises or government-sponsored social housing programmes) are listed under Article 400 of the Capital Requirements Regulation.

⁶⁶ In Austria, Spain, France, Hungary, Luxembourg, Poland and Slovenia, the exemption applies to the whole exposure. In Belgium, Bulgaria, Germany (exemption of 80% of the exposure value), Portugal and Romania, the exemption is only partial, eg by exempting either only part of the exposure or only some types of institutions (eg only banks) (EBA (2016)).

South Africa's transitional approach to interbank exposures

The South African interbank market is highly concentrated, with six D-SIBs representing more than 90% of the assets in the banking sector. These banking groups play a key role in the payments, settlements and clearing processes in the domestic market. The risk that one of these entities may fail constitutes a systemic risk.

In 2022, South Africa issued Directive 3, together with its regulation on measuring and controlling large exposures. Directive 3's annex (Annex 1[Ⓞ]) directs banking institutions to apply specific limits for interbank exposures, including exposures to D-SIBs.

Some areas required consideration prior to the introduction of limits to prevent instability in the interbank market. These included the need for banks to revise their risk appetite frameworks to diversify and/or expand the list of institutions with whom they had business relationships. Another implication related to the trade-off between liquidity and credit risk management. On the one hand, for liquidity purposes, banks prefer investing in short-term and more liquid assets. On the other hand, if interbank exposures are limited in size by the regulation, banks would be obliged to invest in longer-dated, less liquid and/or riskier assets, potentially increasing the portfolio's credit risk profile.

To address these potential concentration risks, South Africa introduced a phased-in approach. To prevent the risk of disrupting the local financial and interbank markets, a limit lower than 25% was introduced for exposures between D-SIBs, with the limit being tightened over three years until it reaches a monthly average of 15%. The three-year phase-in period also associates, for each year, additional limits corresponding to a maximum monthly average and a daily maximum determined as a percentage of the bank's Tier 1 capital. The average and maximum are reduced each year.

Transitional requirements for D-SIBs	1 April 2022–31 December 2022	1 January 2023–31 December 2024	1 January 2025 onwards
Exposures between D-SIBs	Monthly average of 20% Maximum of 25% during the month	Monthly average of 18% Maximum of 20% during the month	Monthly average of 15% Maximum of 18% during the month

Using a monthly average with a maximum daily limit provides banks with some flexibility when managing their interbank assets and liabilities during the month while also limiting the extent to which they may exceed the maximum on any given day. The approach provides operational leeway while also limiting the potential impact and volatility in the interbank market.

[Ⓞ] See Prudential Authority of South Africa (2022b).

Interconnectedness of systemically important banks

59. **The GFC revealed significant levels of interconnectedness within the banking system.**

Although there are many forms of interconnectedness, interbank exposures remain a key transmission channel for contagion risk. The failure of one large bank could affect the sustainability of another bank and have significant implications for the stability of the entire financial system. Because of this, one of the objectives of the LEX standard is to contribute to the stability of the financial system by limiting contagion risk between large international banks, and especially between G-SIBs. Should a large bank fail, the contagion effects can arise through two channels. Market participants may become concerned that other large banks may have similar exposures to those of the failing institution. In addition, they may also be concerned that some large banks may have direct large exposures to the failing large bank.

60. **To contain the systemic risk that arises when a G-SIB has concentrated exposures to another G-SIB, the large exposure limit is reduced to 15% of Tier 1 capital.** When a bank is newly

designated as a G-SIB, the LEX standard provides a time frame of 12 months before the reduced limit is applicable to its exposures to other G-SIBs. To further limit contagion effects between large institutions, the Basel Committee also encourages jurisdictions, at their discretion, to use this reduced limit (or a stricter one) for exposures between D-SIBs and for smaller banking institutions' exposures to G-SIBs.⁶⁷

61. **Jurisdictions have implemented the G-SIB requirement in various ways.** Both North America and Europe, in which 23 out of the 30 G-SIBs included in the list published by the Financial Stability Board (FSB) have their headquarters,⁶⁸ apply the 15% G-SIB limit. In some jurisdictions where there are no designated G-SIBs, the 15% limit has not been introduced in the domestic legislation.⁶⁹ In other jurisdictions with no G-SIBs, the G-SIB requirement has been extended to exposures between D-SIBs.⁷⁰

62. **Regarding exposures to D-SIBs, jurisdictions generally select a limit that is lower than 25% of Tier 1 capital.** The international LEX framework does not prescribe a specific approach, nor does it require the application of a specific limit to exposures between D-SIBs. However, it encourages jurisdictions to determine such limits and to include them in their regulations. Published Regulatory Consistency Assessment Programme (RCAP)⁷¹ reports show that jurisdictions generally select limits that are lower than 25% of Tier 1 capital. This is often the case in jurisdictions with highly concentrated banking sectors, where a few banking groups represent at least three quarters of all the assets in the banking sector.⁷²

63. **Some jurisdictions have introduced different exposure limits according to counterparties systemic relevance.** For instance, Canada's Office of the Superintendent of Financial Institutions (OSFI) considered that extending the 15% limit applicable to Canadian G-SIBs' exposures to another G-SIB to large domestic banks could have adverse local implications and unintended consequences. Consequently, it introduced a higher limit of 20% that applies to Canadian D-SIBs' exposure to other systemically important institutions, whether G-SIBs or D-SIBs.⁷³

64. **Some authorities also rely on internal bank practices and supervisory monitoring tools.** This is the choice made by the Monetary Authority of Singapore (MAS). The MAS expects banks in its jurisdiction to set their own internal limits for exposures to G-SIBs or D-SIBs based on the nature and size of the bank's portfolio. In practice, banks in other jurisdictions, such as South Africa, have also set internal limits that are below the regulatory LEX limits to manage exposures within the requirements. Lower limits create an operational buffer or can serve as an early warning trigger.

65. **One jurisdiction has imposed a lower sub-limit for large exposures held by systemic banks against highly indebted non-financial corporates.** In 2018, France's High Council of Financial Stability⁷⁴ introduced a specific regime applicable to French G-SIBs and D-SIBs limiting their exposure to highly indebted – and therefore vulnerable – non-financial counterparties. Highly indebted non-financial corporates are defined as those that have debt ratios exceeding 100% and where the financial expense

⁶⁷ See BCBS (2023a), paragraph 40.2.

⁶⁸ Every year the FSB publishes, based on a publicly available methodology, a list of banking institutions that are globally systemic (FSB (2022)).

⁶⁹ Such as Argentina, Australia, Indonesia, Singapore, as shown by the respective RCAP reports.

⁷⁰ Brazil, South Africa, and India are examples of such jurisdictions, as shown by the respective RCAP reports.

⁷¹ RCAPs are assessments conducted by a BCBS-appointed assessment team. They review and assess the extent to which the member jurisdiction has adopted – and therefore complies with – the minimum regulatory requirements issued by the BCBS.

⁷² Australia, Canada, and South Africa are examples of such jurisdictions.

⁷³ See OSFI (2019 a and b).

⁷⁴ See French Prudential Supervision and Resolution Authority (2018 a and b). The High Council of Financial Stability is an authority created by law, chaired by the Minister of Finance and in charge of designing macroprudential policy and ensuring financial stability. Its membership includes the central bank Governor, the vice-president of the supervisory authority and the chair of the market conduct authority.

coverage ratio is less than 3.⁷⁵ Only the aggregated exposure to a non-financial firm or to a group of connected non-financial firms exceeding €300 million is taken into consideration. For the seven large financial groups complying with this requirement, a large exposure against a highly indebted firm cannot exceed 5% of the financial institution's Tier 1 capital. The types of exposures considered are the same as under the LEX standard. This subset of large exposures is also part of the seven financial groups required quarterly reporting. The sub-limit also applies on a consolidated basis.

Specific approaches and trading book positions

66. **The LEX framework includes approaches that are specifically designed for certain types of exposures.** These include covered bonds, collective investment undertakings, securitisations and other structures and exposures to central counterparties (CCPs).⁷⁶ Each of these types of exposures has specific characteristics that make it necessary to design a specific treatment for large exposure purposes.

67. **Covered bonds are collateralised exposures issued by a bank or mortgage institution that are backed by high-quality assets.** To the extent that they are also subject by law to special public supervision and because of other protective features build into the transactions' documentation, the bonds' default risk is lower. Accordingly, covered bonds complying with specific regulatory requirements may receive an exposure value for LEX purposes that is 20% of the nominal value of the covered bonds held by the investing bank.⁷⁷

68. **Where a structure lies between the bank and the exposures, a look-through approach (LTA) must be used to determine exposure amounts.** The LTA is applied when a bank invests in funds, securitisations, or other structured transactions with underlying assets. A bank must look through the structure to identify the main underlying assets and identify the counterparty corresponding to each of these assets so that the underlying exposures can be added to other direct or indirect exposure to the same counterparty.⁷⁸

69. **To determine the total exposure to a single counterparty, the LEX standard requires a bank to add any exposures arising in the trading book to those in the banking book.** The trading book exposures to be added correspond to credit concentration associated with the default of a single large counterparty (default risk). Accordingly, positions in financial instruments issued by a counterparty, such as bonds or equities, must be added to those in the banking book and are subject to the large exposure limit. However, concentrated positions in a foreign currency or a commodity are not captured by the standard.

⁷⁵ The debt ratio of the non-financial firm (or group of firms) is defined as the ratio between its total net debt and its capital. The criterion is met when the debt ratio exceeds 100%. The financial expense coverage ratio is the ratio between the non-financial firm's earnings before interest and taxes (EBIT) and its financial expenses. The criterion is met when the coverage ratio is less than 3. The two conditions must be met for the firm or group of firms to be highly indebted.

⁷⁶ The treatment of exposures to CCPs depends upon whether they are qualifying central counterparties (QCCPs). QCCPs are exempted from the large exposure limit. Banks must measure their exposure to non-QCCPs by summing up their clearing exposures and non-clearing exposures. Non-clearing exposures are those that are not directly related to clearing services provided by the CCP, such as funding facilities, credit facilities and guarantees.

⁷⁷ See BCBS (2023a). To benefit from the preferential treatment where the exposure value of the covered bond is reduced to 20% of its nominal value, the covered bond must be subject by law to special public supervision. Only certain high-quality underlying assets are eligible, and the bonds must be over collateralised by at least 10%.

⁷⁸ The complexity and computational burden are increased by the need to consider additional risk factors (or third parties) such as managers, originators, liquidity providers and credit protection providers that are inherent to the structure itself rather than to the underlying assets. For instance, the bank must connect its investments in structures that have a common risk factor, such as a common manager, to form a group of connected counterparties. It must also add its investments in structures associated with a third party that constitutes a common risk factor to other exposures (such as a loan) it may have to that third party.

70. **The exposure value for trading positions to a single counterparty is the gross jump-to-default (JTD) amount.** The JTD is defined under the market risk framework,⁷⁹ with some adjustments. It is the maximum amount that the bank stands to lose from its exposures should this counterparty default. Because of this, no risk weighting and no maturity adjustments are considered, and all instruments are assigned a loss-given-default (LGD) rate of 100%. Like those held in the banking book, sovereign exposures held in the trading book are excluded from the LEX framework.

71. **To determine the trading book exposure to a single counterparty, the LEX framework allows banks to offset long and short positions, subject to conditions.**⁸⁰ For credit derivatives, any reduction in the exposure to the original counterparty must also correspond to a new exposure to the credit protection provider.⁸¹ Offsetting between exposures in the banking book and positions in the trading book is not permitted. If the result of the offsetting is a net short position, the net position is not considered as an exposure for LEX purposes.⁸² The net exposure value for trading book positions to a group of connected counterparties is the sum of positive (ie net long) gross JTD positions for each counterparty within that group.

72. **Approaches and rules for trading book positions, although part of the LEX standard, have not – or not entirely – been implemented in all jurisdictions.** The main reason for not introducing many specific approaches for certain types of exposures in national large exposures regulations is the absence of fully developed, deep and large capital markets in many jurisdictions, especially in emerging market economies. For similar reasons, some jurisdictions may only recognise banking book exposures. Another case of proportionality in some emerging market economies relates to simplified but more restrictive rules for recognising offsets between short and long positions or protection provided through CRM techniques. For instance, offsetting may only be recognised if the positions correspond to the same issue, and therefore have the same characteristics.

Exposures connected with sovereigns

73. **Direct and indirect exposures to sovereigns and public sector entities treated as sovereigns are exempted from the LEX limit, although they still need to be reported.** The exemption⁸³ also applies to central government entities including public sector enterprises (PSEs) treated as sovereigns according to the risk-based capital requirements. In addition to central government entities, some jurisdictions also include states, regions, provinces, or municipalities, especially when they have specific revenue-raising powers.⁸⁴

74. **Where two (or more) entities that are outside the scope of the sovereign exemption are controlled by – or economically dependent on – an entity that falls within this scope, and are otherwise not connected, these entities are deemed not to constitute a group of connected**

⁷⁹ The gross JTD position for non-securitisation exposures is a function of LGD, the notional amount (or face value) of the exposure and the cumulative market-to-market gain (or loss) already realised on the position.

⁸⁰ The conditions are listed under the LEX standard – see paragraphs 30.22–28. In particular, the long and short positions apply to the same issue or to different issues with the same seniority or when the short position is junior to the long position. Credit derivatives hedging positions must also meet this condition for the bank to be allowed to use them as offsets.

⁸¹ This is one of the lessons learned during the GFC. Many international banks had hedged their exposures through credit derivatives that were provided by a small number of credit protection providers (the monoline insurance companies and AIG). As a result, banks had large credit/counterparty risk concentrations on these protection providers.

⁸² This also implies that it cannot offset (and reduce) a net long position of a connected (but legally different) counterparty.

⁸³ One of the side effects of exempting sovereign exposures from LEX is to create an incentive for banks to hold large sovereign exposures and lend to their own sovereign rather than to the economy.

⁸⁴ The two criteria used under the standardised approach for credit risk to determine whether a bank's exposures to regional governments and local authorities may be treated as sovereign exposures are the existence of specific revenue raising powers and specific institutional arrangements the effect of which is to reduce their risk of default.

counterparties. Therefore, the exposures to these entities would not need to be aggregated and would not be treated as a single risk. However, if these two (or more) entities are economically interconnected, they should be treated as a single risk.⁸⁵ In practice, this is not always implemented.

75. **Some jurisdictions interpret the exemption broadly.** Jurisdictions with large public sector enterprises may consider that exposures against all such firms should be treated as exposures to the sovereign and therefore fully exempted from the LEX standard. A case in point is that of a sovereign controlling multiple firms operating at various stages of a value chain. Because these firms are directly or indirectly controlled by the sovereign, they may not need to be treated as connected counterparties based on control. However, these corporations may still constitute a group of connected counterparties, based on economic interdependence criteria.⁸⁶

76. **Exposures connected with sovereigns also raise issues regarding market risk and foreign currency risk.** Commercial undertakings controlled by the sovereign are often among the main issuers of debt and among the main borrowers from the banks. Along with sovereign debt, debt instruments from public sector entities are often highly sought after because of the belief that they are implicitly backed by the sovereign and that they accordingly bear little credit risk. Banks are also often among the main buyers of this debt, something that may become an issue, especially during a market liquidity crisis.

77. **To address these risks, other jurisdictions have narrowly interpreted the sovereign exemption.** This is because some sovereign exposures may be both large and risky, and therefore a blanket exemption may not be justified. In the US, for instance, the large exposure regulation only exempts exposures to sovereigns that are subject to a risk weight of 0% under the standardised approach for credit risk. Moreover, the US supervisory agencies also retain the right to determine, on a case-by-case basis, whether entities that are controlled by a sovereign should constitute a group of connected counterparties,⁸⁷ whereas the LEX framework allows banks to reach such a decision, subject to supervisory approval. In other jurisdictions, such as Mexico, only the domestic sovereign is exempt from the LEX limit.⁸⁸

Exemptions subject to supervisory approval

78. **Exemptions can be granted subject to a predefined approval procedure, even if they are not explicitly provided for in the international standard.** Although there is a range of practices across jurisdictions, these tend to follow a similar logic. Exemptions granted are typically specified in the national regulation, together with the conditions which must be fulfilled.⁸⁹ They are subject to a supervisory approval procedure where the exemption must be obtained in advance, ie before the exposure for which the exemption is sought breaches the limit. Finally, these exemptions are generally time-limited, although they may be renewed if the conditions that justified them are still fulfilled.

79. **The non-renewal of the exemption typically triggers a request for the bank to elaborate a remediation plan.** The plan must be accepted by the supervisory authority before it is implemented by

⁸⁵ Many jurisdictions have large public sectors with sovereign-controlled companies including large utilities, energy companies and state monopolies. These are typically among the largest bank borrowers. They are sometimes portrayed as “national champions” and may sometimes be also used by the state to fulfil economic policy objectives.

⁸⁶ There are several examples across jurisdictions of firms that belong to the public sector and which, because of their activities, could be considered interconnected. These could include firms working together on high-value projects, including mining or defence projects, or firms active in oil and natural gas exploration and production.

⁸⁷ See Board of Governors of the Federal Reserve System (2018, 2020a), and particularly 12 CFR 252.76 of FRB’s Regulation YY.

⁸⁸ See National Banking and Securities Commission (CNBV) (2023).

⁸⁹ In the US, for instance, 12 CFR 252.78(c) of the FRB’s Regulation YY includes limited cases where a covered company exceeding its limit would not be subject to enforcement actions with respect to non-compliance for 90 days. These limited cases include the merger of two banks, the merger of two unaffiliated counterparties and “any other circumstance the Board determines, in its discretion, is appropriate”. When granting approval, the Board can impose supervisory oversight and reporting measures.

the bank. Several of the authorities interviewed, including the JFSA and the AIFC, expressed the view that although the LEX standard does not explicitly provide for such exemptions, an exceptional treatment whereby exemption can be obtained subject to prior supervisory approval was necessary to provide flexibility and address specific cases. In practice, there are three main categories of exemptions.

80. **The first type of exemption defined in regulation covers any exposure that would breach the LEX limit because of specific circumstances.** Typically, these circumstances may include bank resolution and/or cases of mergers and acquisitions between two banks. They may, however, also include “other appropriate reasons”⁹⁰ or be deemed necessary to preserve the safety and soundness of the covered company or to preserve the stability of the financial system, as in the US.⁹¹ These cases include exemptions granted for the duration of a remediation plan, with the supervisor subjecting the bank to a close monitoring regime for all exempted exposures.

81. **The second type of exemption includes cases where exposures to specific counterparties may be exempted for a predetermined period and for designated banks.** While the design of exemptions may vary across jurisdictions,⁹² they are also mostly used in cases of mergers and acquisitions, whether between financial institutions or between large corporates.⁹³ The purpose is to avoid disruption in the provision of credit to large corporates and to provide time for banks to become compliant either by raising capital or by redistributing the credit risk.

82. **The third type of exemption relates to exceptional circumstances where compliance is temporarily lifted for all banks and counterparties.** Such exemptions are relatively rare. They tend to be granted during crisis periods when events leading to breaches are beyond banks’ control and where enforcing compliance could further compromise their safety and soundness. Such exemptions are granted through specific regulation issued by the supervisory authority, with the regulation prescribing the conditions to be met and the period during which the exemption will apply.⁹⁴

Section 5 – Credit risk mitigation (CRM) techniques and challenges

83. **CRM techniques must be considered when determining whether a bank’s large exposures comply with the LEX limit.** There are two main sets of implementation challenges related to CRM techniques. The first has to do with verifying the eligibility of CRM techniques used by banks. The second is about assessing and determining the effectiveness of the protection provided and the extent to which it may reduce the value of the large exposures and help banks comply with the LEX limit.

⁹⁰ The JFSA’s regulation states that the compelling reasons for making an exception to the implementation of the large exposure limit include: (i) a merger based on the Deposit Insurance Act; (ii) a temporary reduction of capital; and (iii) other cases found to be appropriate by the Commissioner of the JFSA (BCBS (2022b)).

⁹¹ For instance, US regulations allow a bank to exceed the regulatory limits if it obtains prior approval from the FRB. This prior approval can be granted in cases where the FRB determines that such credit transactions are necessary or appropriate to preserve the safety and soundness of the covered company or to preserve the stability of the financial system.

⁹² For example, exposures to specified counterparties may be exempt from the LEX limit, or specific counterparties may be exempted from being considered part of a group of connected counterparties.

⁹³ For instance, JFSA regulations provide that if the total amount of credit extended by a bank or bank holding company to a single person exceeds the large exposures limit because of a merger or business acquisition by the person to which the credit is extended, then the large exposure limit does not apply.

⁹⁴ For instance, the Ruling of the Board of National Bank of Republic of Kazakhstan N170, Amendment of Article 58 (p 3) granted an exemption from the large exposure limits between 21 February 2022 and 31 December 2022 for all breaches occurring because of reductions in banks’ capital due to circumstances outside the bank’s control. These related to reevaluations of banks’ assets and liabilities due to changes in the local currency rate and/or changes in the composition of the bank’s assets and liabilities denominated in foreign currencies. See National Bank of the Republic of Kazakhstan (2017).

Eligibility of CRM techniques

84. **Eligible CRM techniques are limited to those recognised under the standardised approach for risk-based capital requirements.** They are therefore limited to unfunded credit protection (guarantees and some credit derivatives), financial collateral eligible under the standardised approach and on-balance sheet netting.⁹⁵ Other forms of commonly used collateral, such as receivables and real estate, are not eligible mitigants under the LEX standard.

85. **To be eligible, guarantees and credit derivatives must satisfy the operational requirements of the CRM framework.** Some requirements apply to all CRM techniques while others apply to specific instruments. Their purpose is to ensure the legal certainty and the effectiveness of the protection. To ensure the effectiveness of unfunded protection, guarantees and credit derivatives must represent a direct claim on the protection provider, and explicitly reference specific exposures or a pool of exposures so that the protection is clearly defined and incontrovertible. They must also be irrevocable and unconditional.⁹⁶ When all requirements are fulfilled, the bank can reduce the value of the exposure by the value of the protected portion. However, it must also recognise an exposure to the protection provider for the same amount.

86. **Eligible financial collateral is limited to cash, gold and debt instruments or high-quality equity.**⁹⁷ Eligible debt securities issued by sovereigns or public sector entities are generally those that are treated as sovereigns by the national supervisor, while eligible corporate debt is restricted to that issued by corporates that are at least investment grade. To determine the net exposure value, banks may opt for either the simple approach or the comprehensive approach used under the CRM framework. When using the simple approach, the exposure value is reduced by the market value of the financial collateral. When using the comprehensive approach, the exposure value is reduced by the value of the collateral after applying the CRM supervisory haircuts.⁹⁸

87. **In many jurisdictions, the scope of eligible CRM techniques is narrower than what the LEX standard recognises.** This is the case in most emerging market economies. In the absence of developed capital markets, unfunded credit protection tends to be limited to guarantees, whereas financial collateral is mostly made up of cash or sovereign debt securities, since few – if any – corporates are investment grade. While unrated debt securities issued by a bank may qualify, few banks issue securities, issues are generally small, and they also tend to be illiquid.

Challenges related to assessing the effectiveness of CRM techniques

88. **An overarching challenge is the level of complexity involved when assessing the effectiveness of CRM techniques.** While the LEX standard requires that banks report both gross and net large exposures, additional supervisors need additional information to check the effectiveness of CRM instruments. To ensure they provide sufficient legal certainty, the supervisor would in theory need to examine all relevant contractual documentation for all instruments used. For financial collateral, this includes the ability to ensure that the collateral exists, is unpledged and otherwise available, and that it is

⁹⁵ Banks that have legally enforceable netting arrangements for loans and deposits that meet the conditions in CRE22.68 and CRE22.69 may determine their exposure values for large exposures based on the net credit exposures as set out in the approach to on-balance sheet netting under the CRM framework.

⁹⁶ The list of eligibility criteria and operational requirements for eligible guarantees and credit derivatives can be found in the standardised approach for credit risk of the Basel Framework in paragraphs CRE22.70 to CRE22.84.

⁹⁷ In practice, equity of the highest quality typically corresponds to that listed on a major exchange. Eligible collateral may also include undertakings for collective investments in transferable securities (UCITS) and mutual funds where a price for the units is publicly quoted daily, and the UCITS/mutual fund only invests in the instruments listed as eligible.

⁹⁸ While the comprehensive approach is more complex, it allows for a more precise offset of collateral against exposures by reducing the exposure amount by a volatility-adjusted value (the supervisory haircut) that is ascribed to the collateral.

prudently valued. For guarantees, this would imply the ability to assess the credit quality and financial position of the guarantor and, for credit derivatives, the need to verify and ensure that the underlying reference entity and default events are such that the protection would effectively be triggered should the bank's counterparty default.

89. **As reporting requirements set out by the LEX standard are minimal, the contents of national reporting vary.** Some jurisdictions only require banks to report the aggregated gross exposure before CRM and the net exposure after it has been reduced by CRM techniques and reserve the right to require breakdowns and extensive legal documentation and explanations as they see fit. Others have more detailed and prescriptive requirements and may require much more information that can help demonstrate the effectiveness of the protection. However, they may not always be able to use this information to verify the effectiveness of CRM techniques for all banks given how resource-intensive and time-consuming such verifications can be.

90. **Faced with these challenges, some jurisdictions have chosen to be more conservative than others.** Many emerging market jurisdictions do not recognise credit derivatives among eligible CRM techniques for large exposure purposes, as these instruments are illiquid, rare or do not exist in their jurisdictions. Others restrict the offsetting of exposures. For instance, the US does not recognise balance sheet netting between assets and deposits.⁹⁹ Some jurisdictions, such as South Africa, allow banks not to recognise an eligible CRM when calculating an exposure to an obligor for the purpose of large exposure limits.¹⁰⁰

Section 6 – Reporting and supervisory monitoring

Reporting requirements and practices

91. **The LEX standard requires a bank to report all its large exposures to the supervisory authority.** A bank is required to report any exposure that is equal to or above 10% of its Tier 1 capital, before considering any CRM effects. Even when exempted from the LEX limits, exposures are still subject to regulatory reporting and disclosures. In addition, banks are expected to report their top 20 exposures to counterparties, even if the exposures do not meet the definition of a large exposure.¹⁰¹

92. **All supervisory authorities interviewed receive large exposure data at least on a quarterly basis.** Many authorities also collect detailed information on all components that are relevant in the exposure measurement of large exposures to be able to verify the bank's compliance. In addition, due to the importance of interconnectedness in the LEX standard, many authorities also collect data on counterparties that form part of a group of connected counterparties.¹⁰² In all jurisdictions interviewed, the supervisor has the power to request more frequent and/or detailed reporting, especially in the event of a troubled institution or if circumstances warrant more frequent/detailed monitoring.

93. **Although all supervisors collect data on large exposures, the extent of banks' reporting varies considerably between jurisdictions.** The LEX standard does not prescribe or recommend a standard template for the reporting of large exposures, and practices differ significantly across jurisdictions. In some instances, authorities receive data on all the components constituting a large

⁹⁹ See BCBS (2023c).

¹⁰⁰ See BCBS (2023b).

¹⁰¹ See Basel Framework, LEX 20 – Requirements, paragraph 20.4.

¹⁰² Two examples are the reporting templates of the FRB in the US (see Board of Governors 2020b) and of the Bank of England's PRA (See Bank of England Prudential Regulation Authority (2022b and c)).

exposure (on-balance sheet, off-balance sheet, derivatives, CRM techniques etc) while in other cases only the name of the counterparty and the overall size of the exposure in relation to Tier 1 capital is collected.

94. **Several authorities go beyond the requirement of collecting data on the 20 largest exposures.** The FRB requires banks under its supervision to report the 50 largest exposures, irrespective of the exposure value relative to the bank's capital base. This gives the supervisor insight into a wider spectrum of counterparties. In the European Union, all exposures exceeding €300 million must be reported even when they do not exceed the LEX reporting threshold. In Kazakhstan, the AIFC applies a form of proportionality to the reporting requirement, depending on the size of the reporting institutions. If the reporting bank is deemed to be large by the supervisory authority, it is expected to increase the number of reported exposures from the top 20 to the top 50 counterparties.

95. **In-depth analysis of collected data is essential but also challenging to perform.** As alluded to earlier, the supervisor largely depends on the quality of an institution's reporting, with each bank expected to determine and accurately report its own large exposures. Verifying the accuracy and comprehensiveness of reported data is challenging, complex and resource intensive. Only a few of the authorities interviewed had tools in place to assess reported large exposures and automatically detect breaches. Most supervisory authorities conduct ad hoc – and therefore exceptional rather than systematic – analysis on large exposures because of resource constraints. Many authorities also use on-site examinations to conduct in-depth reviews and assessments of the quality of the institution's reporting. Information collected during on-site examinations is also used to compare the treatment of groups of counterparties across reporting institutions and identify discrepancies.

96. **Structured data and the use of artificial intelligence may offer the opportunity to use automated tools to monitor regulatory reporting.** While the use of structured data¹⁰³ is not new, the emergence of automated tools may help aggregate and analyse reported exposures more systematically as part of the off-site supervisory processes. A large exposure monitoring tool can be built with many functionalities, including the ability to detect whether aggregated exposures against counterparties may be close to the regulatory limit. It may also be able to detect and assess cases where banks are significantly under provisioned, and therefore reporting inflated regulatory capital and minimising their large exposures. Automated consistency checks and supervisory databases, with controls and checks across banks, would help to ensure that treatments of interconnected counterparts and of credit risk mitigants are consistent.

Section 7 – Breaches, supervisory measures and return to compliance

97. **The LEX standard requires that limit breaches, which are to be exceptional, must be communicated immediately to the supervisor and rapidly rectified.** Despite these requirements, breaches are not always addressed immediately. Moreover, there can also be a need to consider specific circumstances. Accordingly, practices vary across jurisdictions as authorities seek to tailor their responses to fit reality. Examples of varying practices include the scope of breaches that should be recognised as "exceptional", the meaning of "immediately" when referring to the communication of breaches to the supervisory authority, and of "rapidly" when referring to the speed with which the breach should be addressed. Finally, the actions the supervisor needs to take so that the bank returns to compliance vary according to the circumstances of the case and across jurisdictions.

¹⁰³ Structured data refers to data that are collected in a standardised format through a predefined template such as the ones used by supervisory authorities to collect data from reporting institutions on large exposures. Similarly, artificial intelligence may offer the opportunity to monitor unstructured data collected for large exposures, for individual reporting institutions as well as cross checks amongst reporting institutions.

Identifying breaches

98. **The supervisory authority must first identify a breach.** Given the self-declarative nature of the LEX standard, with the bank reporting its own large exposures, the supervisor typically becomes aware of a breach either when it is informed of it by the bank itself, as part of its off-site monitoring or during an on-site supervisory examination. In most jurisdictions, supervisory responses differ depending upon whether the breach is reported by the bank or discovered by the supervisor.

99. **Despite the requirement for breaches “to be communicated immediately”, practices differ between jurisdictions.** Differences in the speed with which breaches are reported are largely related to differences in supervisory reporting procedures. For instance, some jurisdictions require the reporting of breaches within a short period (eg 48 hours) of their identification by the bank. Other jurisdictions consider that a breach does not need to be reported when the bank solves it within a specified delay (typically two to three days). In both cases, the communication of breaches is not immediate, and in the second case the supervisor may never find out about it. Finally, some countries have put in place reporting systems fed by bank data whereby large exposures are calculated and reported automatically. However, even in such cases, banks and supervisors need to check data components and validate breaches.

100. **The contents of breach reporting also differ across jurisdictions.** While the LEX standard specifies the information to be periodically reported for large exposures, there are no requirements for how breaches should be reported. In practice, the information periodically reported is insufficient and does not allow for further supervisory investigation and action. It may include the value and name of the aggregated exposure, although in many cases only the codified number of the exposure is reported. Given the limited value of such information, most supervisory authorities require that additional information¹⁰⁴ be communicated. Supervisors may also require qualitative information such as the causes of the breach and the bank’s estimate of the time needed to address it.

101. **Supervisors may also discover breaches as part of an on-site examination or (more rarely) an off-site review.** The investigation of a “potential breach” can be complex and often involves an intensive supervisory dialogue and strong technical capabilities, particularly when the interconnectedness of counterparties and the effectiveness of credit risk mitigants needs to be assessed. This kind of oversight can be challenging, especially when banks (and their external auditors) disagree with the supervisor’s views.

102. **It is relatively rare for supervisors to identify breaches on their own.** This is largely because verifying all a bank’s exposures to determine whether and to what extent it has adequately reported all its large exposures would be so demanding, complex, and time-consuming for supervisors that it becomes impractical, especially for larger banks. The need to verify and assess the bank’s assumptions and computations on a case-by-case basis means that no supervisory agency has sufficient resources and expertise to conduct in-depth, periodic, and systematic reviews of all bank exposures at all banks. In practice, most reviews of a bank’s large exposures take place during on-site examinations. They can involve checking and recalculating the large exposures declared by the bank and in-depth checks on a sample of its largest exposures. Some supervisors extend their review to all exposures declared as large.

103. **Given the importance of credit concentrations and the difficulties in exercising comprehensive oversight, more risk-oriented approaches are under development.** Some supervisory authorities are designing approaches to identify circumstances where the probability of a breach may be

¹⁰⁴ For instance, the EBA’s guidelines include the list of quantitative and qualitative information to be provided to the competent authority when the large exposure limit is breached. Information includes the amount of the excess and the magnitude of the breach in relation to Tier 1 capital, the names of interconnected clients and the name of the group, the date of occurrence, a description of collateral, a detailed explanation of the reasons for and circumstances of the breach and of the remedial actions (whether implemented or planned), and a timeline to end the breach. The authorities have the power to request any further information if necessary (see EBA (2021)).

higher and seek to prioritise their supervisory resources accordingly.¹⁰⁵ Other efforts involve comparing banks' aggregations for groups of connected counterparties. Some groups of counterparties may be selected because their creditworthiness is challenged. Others may be chosen because they have been involved in cases of under- or misreporting of interconnectedness. Some jurisdictions have also developed a practice of verifying extensively every new large exposure added by the bank in its reporting.

104. **In the absence of common guidance, national practices are mostly informed by domestic cross-sectoral analysis and by experience.** Experience refers to the identification of the main risk indicators, often those observed in previous breaches. Sectoral indicators include cases where exposures of counterparties operating in the same sector(s) may be more subject to breaches because of the structure of the sector and of the financial system.¹⁰⁶ Provision-related indicators are those where the supervisor detects the existence of large under provisioned loans, which, had they been adequately provisioned, would have led to a large loss that would have reduced the bank's Tier 1 capital and resulted in LEX breaches. Compliance and internal models-related indicators refer to cases where the bank fails to adequately report some of its large exposures, reports large exposures with ineligible or inadequate CRM or fails to identify, aggregate and report interconnected exposures.¹⁰⁷ Another category of early warning indicators that may trigger in-depth verification is the reporting of net exposures whose sizes are very close to the standard's limit so that "window-dressing" practices may be suspected.¹⁰⁸

Analysing breaches

105. **In most of the jurisdictions interviewed, reported breaches are relatively rare in absolute numbers.**¹⁰⁹ In practice, determining whether a breach is exceptional can be difficult. Analysing the cause and nature of the breach and considering the bank's history of previous breaches (if any) help supervisors determine whether a breach is exceptional and to what extent corrective measures need to be taken to remedy it.

106. **To assess whether a breach is exceptional, some authorities rely on quantitative data.** The typical indicator is the frequency and number of breaches that may have occurred at the bank over the past 12 months. For instance, the EU supervisory authorities¹¹⁰ may decide that a bank's breach cannot qualify as "rare" if it has reported a second breach during the past 12 months for the same client or group of connected clients. Alternatively, if, during the past 12 months, the bank has already reported at least two breaches on different counterparties, any further breach, regardless of the counterparty, would no longer qualify as exceptional.

107. **The assessment may also include qualitative information referring to existing and past breaches.** The existence (or the absence) of similarities between breaches, with these having (or not) the same causes and origins, is considered when assessing whether a breach is exceptional. For instance, breaches will clearly not be exceptional when they are repetitive in nature and due to previously detected

¹⁰⁵ Examples where supervisory investigations are recommended include cases where the bank's management is poorly rated and where large exposures are cases of related party lending. The next paragraph contains more examples.

¹⁰⁶ In other words, the sector and/or the financial system are concentrated, with a sector made up of a few very large firms and their service providers financed by a few large domestic banks.

¹⁰⁷ The ECB uses similar risk indicators, which it calls "LEX investigation triggers", see ECB (2022).

¹⁰⁸ Such practices may be more likely when the bank's capital is assessed as barely adequate.

¹⁰⁹ Nevertheless, they may represent a significant proportion of all breaches identified across a banking system.

¹¹⁰ See EBA (2021).

and non-addressed deficiencies in risk management. Peer group analysis is used by supervisors to help identify cases where similar factors may cause breaches at several banks during the same period.¹¹¹

108. **Force majeure considerations may lead a breach to be qualified as exceptional.** This requires determining whether the breach was caused by reasons beyond the bank's control; there is a range of reasons, with some examples mentioned in national regulations or supervisory guidelines. The most frequent cause stated by jurisdictions is an unexpected (and material/substantial) decrease in the bank's capital.¹¹² Supervisory guidance may be used to further clarify and specify the causes of these sudden capital shortfalls.¹¹³ Less frequent causes of breaches that are beyond the bank's control include court rulings which could, for instance, change the nature or the value of an exposure or of its collateral, an administrative decision leading to a change in the way the large exposure framework is interpreted or cases when an exposure may cease to be exempted.

109. **"Unpredictability" may also allow a breach to be deemed exceptional.** In such cases, the supervisor needs to assess whether the breach was foreseeable by the bank, assuming its risk management framework complies with all governance and risk management guidelines issued by the authorities. Predictability may also be assessed by analysing whether the bank should have been able to anticipate the breach by using all available information. Such complex analysis may be used when breaches relate to merger and acquisition transactions with the large exposures involved being temporarily authorised by the supervisor.¹¹⁴

110. **Other types of breaches would not be recognised as exceptional or beyond the bank's control.** This is particularly the case when breaches are caused by deficiencies in the risk management, control, or governance frameworks, or by inappropriate application or misinterpretation of the LEX standard. Many authorities confirmed such views during the interviews, with some having explicitly included statements to this effect in their guidelines.¹¹⁵

Corrective measures

111. **Understanding the nature of a breach is a prerequisite for determining corrective measures.** The supervisory response tends to vary along two lines: whether the breach is qualified as exceptional and whether it was reported by the bank or discovered by the authorities. In practice, however, a significant part of breaches may have been remediated and addressed by the bank when reported to the supervisors. In such cases, there is generally no need for corrective measures.¹¹⁶

112. **Breaches qualified as exceptional generally trigger a supervisory request to submit a remediation or compliance plan.** To the extent that the breach is exceptional and/or outside the bank's control, there are no other consequences for the bank, meaning no actions are taken against it or its

¹¹¹ According to the EBA's guidelines, the competent authority might conclude that the breach was caused by an unforeseeable event in cases where identical or similar breaches of other banks occur that could be attributed to the same cause.

¹¹² In Japan, a "temporary reduction in capital" may be a valid cause for an "temporary exemption".

¹¹³ For instance, Kazakhstan's guidance mentions that a sudden contraction occurs as a "result of the lowering of bank's capital due to circumstances not depending on the bank and due to the change of the currency structure of the assets and liabilities". For force majeure and unpredictability, the EBA's guidance mentions a "decrease of own funds..., including due to the impact of major operational risk events, such as external fraud, natural disaster or pandemic, that are not linked to a failure of the institution's internal control mechanisms".

¹¹⁴ For example, the JFSA's regulation has "M&A provisions" for breaches.

¹¹⁵ The EBA's guidelines explicitly state that such breaches can be considered as beyond the bank's control when the institution did not have knowledge of, or could not have anticipated, this merger or acquisition to prevent a breach (EBA (2021), p 16).

¹¹⁶ There would, for instance, be no need for the supervisory authority to take corrective measures when a breach of the LEX limit has been followed by the sale of a portion of the exposure, unless this kind of breach were to become a regular occurrence.

management. Typically, such a plan combines a set of actions and measures which, when implemented together, will allow the bank to return to compliance within a predetermined time frame.

113. **Although contents are case-specific, remediation plans typically include three types of measures.** The first type is arrangements and measures taken to reduce the size of the exposure or increase the bank's capital position so that the exposure will no longer breach the limit. These two sets of measures are often combined.¹¹⁷ The second type of measures includes those aimed at reinforcing the bank's risk management and its internal controls, since many breaches are at least partly due to deficiencies in risk management and internal controls. The third type of measures are those needed to ensure the plan's execution, such as a time frame with the date by when the bank is expected to become compliant again and supervisory checkpoints that allow the supervisory authority to monitor progress. Remediation plans may also include a requirement for the bank to have an internal procedure to ensure the timely implementation of all measures contained in the plan.

114. **For breaches that do not qualify as exceptional, the remediation plan may be combined with oversight measures.** For example, a bank that breaches the LEX limit several times a year may become subject to more intensive and more frequent risk management and governance reviews by the supervisor, but also to fines,¹¹⁸ especially in the case of serial breaches. Such a bank is also likely to have its supervisory rating downgraded. The supervisory authority may also require a capital surcharge until the root causes of the breaches (such as risk management deficiencies) have been fully addressed.

115. **Partial deduction from the bank's capital is a supervisory measure that creates a strong incentive to return to compliance.**¹¹⁹ Requiring the deduction of the fraction of the exposure that exceeds the large exposure limit from the bank's capital may not address the root causes of breaches, but it is a powerful incentive for the bank to address the breach. However, supervisory authorities have mixed views regarding the efficiency of such measures. Some authorities appreciate their simplicity and the powerful incentives they provide. Others consider that they are less flexible than remediation plans or even potentially counterproductive as they may trigger further LEX breaches.

116. **Unreported breaches discovered by the supervisor are often subject to harsher measures.** Breaches are typically identified by supervisors during on-site examinations, with the bank subsequently subject to a more far-reaching supervisory action plan beyond remediation. Corrective measures may include demands to improve the risk management, including the recruitment and/or replacement of senior management and the imposition of fines.¹²⁰ Calibration of the fines may represent a specific challenge, with fines typically representing a percentage of the bank's capital or a percentage of the large exposure that caused the breach.¹²¹ In practice, however, supervisors may hesitate to impose harsh corrective measures, especially when the bank still complies with minimum solvency and liquidity requirements.

¹¹⁷ Measures taken to reduce the size of the exposure include selling part of it to other banks or mitigating the risk through the obtention of an eligible guarantee or of collateral. Additional measures to reduce the exposure can include early repayment or, in rarer cases, debt restructuring. Measures aimed at improving the bank's capital position include raising capital, retaining profits, and, more generally, obtaining support from existing shareholders.

¹¹⁸ See ECB (2017, 2018 and 2019a) for administrative penalties issued by the ECB for non-compliance with the LEX requirements.

¹¹⁹ For instance, Mexico has introduced such an incentive in its LEX framework, see National Banking and Securities Commission (CNBV) (2023).

¹²⁰ See ECB (2019b) for the imposition of an administrative penalty on Natixis Wealth Management Luxembourg for, among other things, reporting inaccurate information on its large exposures. For other cases where the ECB has imposed administrative penalties for breaches of the large exposure requirements, see ECB (2017, 2018 and 2019a).

¹²¹ The Kazakhstan authority applies a fine of up to 1% of the value of the exposures that led to the breach. This applies to cases of "repetitive breaches" that do not comply with the definition of exceptional breaches.

Time frames to return to compliance: theory and practice

117. **When a bank breaches the limit, the supervisory authority tends to provide it with a delay to return to compliance.** The right to grant such a delay may be either part of the supervisor's discretionary powers or a specific power granted by regulation to address LEX breaches.¹²² In practice, supervisory responses to breaches, and the time needed to return to compliance, are typically based on the specifics of each case and on supervisory judgment. Jurisdictions that have explicitly given supervisors the power to grant such a delay have generally done so to reduce the scope of supervisory discretion, limit the risk of forbearance, ensure common and consistent implementation¹²³ and provide a legal basis, including in cases where supervisory decisions may be challenged in court.

118. **The average delay to return to compliance tends to be short despite a range of practices.** In many jurisdictions, regulation does not specify the length of the delay as breaches are supposed to be rare and are expected to be addressed as soon as possible. While other jurisdictions do specify the length of the delay that can be granted, they may also allow for the possibility to provide a longer delay if needed.¹²⁴ In practice, delays granted by supervisory authorities tend to range from one to three months.¹²⁵ Under exceptional circumstances, delays reaching to up to a year can be provided.¹²⁶

119. **Some jurisdictions have provided criteria to help decide whether exceptional circumstances justify granting a remediation period.** Although supervisors share the view that exceptional circumstances leading to a breach can justify granting a delay to return to compliance, deciding when this is the case and how long the delay needs to be is challenging. To help supervisors decide and to ensure consistent implementation, some jurisdictions have issued guidelines containing general criteria. The guidelines may also help determine the delay that can be granted in specific circumstances. The guidelines issued by the EBA are among the most elaborate and detailed, with the criteria to consider for granting delays derived from supervisory good practices and summarised in the box below.¹²⁷

¹²² EU Regulation (EU CRR, Article 396(1)) explicitly states that "the competent authority may, where the circumstances warrant it, allow the institution a limited period of time in which to comply with the limits".

¹²³ Ensuring harmonised and comparable implementation across national authorities is a main objective of EU regulations.

¹²⁴ See EU CRR, Art 396(1). According to this regulation, a competent authority may allow, in exceptional cases, an institution to exceed the regulatory limit for a period exceeding three months. In such cases, "the institution shall present a plan for a timely return to compliance with that limit to the satisfaction of the competent authority and shall carry out that plan within the period agreed with the competent authority. The competent authority shall monitor the implementation of the plan and shall require a more rapid return to compliance if appropriate".

¹²⁵ This was evidenced during the interviews with the selected supervisory authorities.

¹²⁶ While most periods granted are limited to three months or less, there are cases where longer periods are needed, for instance when additional capital needs to be raised either from the bank's shareholders or through a public offering on capital markets.

¹²⁷ See EBA (2021) for a full discussion on the guidelines specifying the criteria to assess the exceptional cases when institutions exceed the large exposure limits of Article 395(1) of Regulation (EU) No 575/2013 and the time and measures to return to compliance pursuant to Article 396(3) of Regulation (EU) No 575/2013.

EBA guidelines

Criteria to assess exceptional breaches in the European Union

The purpose of these guidelines is to provide criteria to help supervisory authorities within the EU to: (i) decide whether the exceptional circumstances leading to a breach of the large exposure limits would justify allowing an institution a limited period to become compliant again; and (ii) decide what this time period needs to be. The guidelines also include guidance for standard, maximum and exceptional time periods (item iii)).

i. The criteria to assess whether a period to return to compliance may be granted are the following:

- the institution's record of breaches;
- the promptness with which the bank has notified of the breach or the actions taken to return to compliance;
- the reasons, complexity, and magnitude of the breach;
- the overall financial situation of the institution;
- the overall risk concentration in the banking book;
- the type of counterparty and its creditworthiness; and
- the measures already taken to address the breach.

ii. To further help supervisory decisions, the EBA provides detailed recommendations, such as:

- A breach which is repetitive in nature, due to the same cause, triggered by the same event or concerning the same exposure, should not be grounds to grant an institution more than three months to resolve it.
- The competent authority should not grant an institution more than three months to resolve a breach when its magnitude could have a major impact on the institution's financial situation.
- If an institution unduly delays the notification of a breach, the competent authority may consider giving the institution a shorter time frame to return to compliance.
- An institution with a less favourable financial situation might need more time to implement certain measures to return to compliance or otherwise risk a worsening of its financial situation.
- The assessment of the banking book may reveal that an institution is not highly exposed to concentration risk across different counterparties. In this case, the competent authorities might feel more confident allowing a longer period to return to compliance since this could suggest that the institution has a diversified risk management strategy.
- The competent authorities might feel more confident allowing a longer period to return to compliance when the counterparty of an exposure has a low risk profile; conversely, they might feel the need to ensure a more rapid return to compliance when the counterparty of an exposure has a high-risk profile.

iii. Standard, maximum, and exceptional time frames for resolving large exposure breaches:

- Following the assessment performed based on these criteria, the competent authority should be able to determine the time considered appropriate for returning to compliance.

In particular, the competent authority should decide whether the breach should be resolved within three months, or whether it should grant the institution more time to return to compliance.

In the latter case, competent authorities should not grant a period of more than one year. There may be extraordinary cases that would warrant granting a period exceeding a year. However, such cases should be rare and need to be well justified.

Section 8 – Conclusions

120. **The purpose of the LEX standard is straightforward.** It limits risks arising from concentrated exposures on a counterparty or a group of connected counterparties. It is designed to complement the risk-based capital standard so that the maximum loss a bank could incur if a single counterparty or group of connected counterparties were to fail would not endanger the bank's survival. It is also expected to help limit the risk of contagion between systemically important banks.

121. **While conceptually simple, the LEX standard is technically complex and resource- and time-intensive to verify.** The complexities primarily arise from the need to capture all kinds of exposures against a counterparty, including market-based products and trading positions for which specific treatments need to apply. Supervising the standard relies on case-by-case analysis and supervisory judgment. Judgment is needed to assess to what extent counterparties are connected and whether they should be considered as a single risk. It is also needed when applying the various treatments and approaches to each type of exposure. Finally, it is needed to assess the eligibility and effectiveness of CRM techniques and their ability to reduce the value of the large exposures at risk. As a result, achieving fair, consistent, and effective supervision of the LEX standard is a complex and resource-intensive task.

122. **When exercising their oversight, supervisory authorities depend largely on the goodwill of reporting banks.** The LEX standard is a self-declaration regime wherein the bank reports its large exposures, seeks carve-outs and exemptions based on the information it provides to the supervisory authority and is expected to declare and report any breach "immediately". Most breaches are brought to the supervisor's knowledge by the bank itself rather than being identified by the supervisory authority. In practice, risk-oriented supervision, and proactive supervisory actions where efforts are made to identify banks likely to report breaches before these occur and address them pre-emptively are relatively rare.

123. **There is room for technology-enabled automated tools to increase the efficiency of supervisory oversight.** As many jurisdictions have realised, the supervisory challenges associated with the standard's implementation are such that no supervisory authority has sufficient human resources and expertise to ensure that all large exposures at all reporting banks are subject to systematic, periodic, and in-depth checks. Tools include automated cross checks across banks to compare large exposures and groups of interconnected exposures declared by banks. A supervisory database containing groups of connected counterparties would constitute an alternative that would help to ensure consistent reporting across banks and jurisdictions. Another type of tool is one that allows supervisors to identify the most likely cases to lead to breaches or to help to hide existing breaches based on supervisory experiences. Such risk indicators could include cases where aggregated exposures regularly but barely comply with the limit or where the portion of the exposure exceeding the limit is subject to risk mitigation measures.

124. **Reporting requirements are an area where the standard's oversight may benefit from more harmonised practices.** These are currently limited, and there are no requirements on how to report breaches. To help supervisory authorities enforce the standard and ensure banks' compliance, there could be value in designing detailed common reporting templates and supervisory guidelines that would lay out the Basel Committee's expectations regarding the standard's implementation and the controls and checks that supervisory authorities should be expected to conduct when exercising their oversight. This would encourage sound supervisory practices when assessing interconnectedness and CRM techniques.

125. **International guidance could allow supervisors to share and develop common practices across jurisdictions.** Such guidance could take multiple forms, ranging from sets of interconnectedness case studies based on supervisory practices and findings, to the design of additional interconnectedness criteria that all jurisdictions would be expected to apply. International guidance could also be useful in harmonising practices related to the detection, analysis, and resorption of breaches. These guidelines could help supervisors assess the causes of breaches, determine whether they are exceptional or not and recommend the most appropriate supervisory approach to return the bank to compliance.

References

Bank of England, Prudential Regulation Authority (BoE PRA) (2010): *CP10/17: Strengthening Capital Standards 3 - feedback to CP09/29 final rules for CRD2, and further consultation*, July.

——— (2014): *Related Party Transaction Risk*, February.

——— (2020): *"Don't put all your eggs in one basket": protecting banks from the failure of individual counterparties*", *Quarterly Bulletin*, June.

——— (2022a): *Large Exposures (CRR) - Prudential Regulation Authority*, January.

——— (2022b): *Forms - Prudential Regulation Authority (Template C 26.00 to C 29.00)*, January.

——— (2022c): *Annex IX: Instructions for reporting on large exposures and concentration risk*, January.

Basel Committee on Banking Supervision (BCBS) (1991): *Measuring and controlling large credit exposures*, January.

——— (2000): *Principles for the management of credit risk*, October.

——— (2012): *Core principles for effective banking supervision*, September.

——— (2018): *Regulatory Consistency Assessment Programme – assessment of Basel large exposures framework – Kingdom of Saudi Arabia*, September.

——— (2019a): *Basel Framework SCO 10*, December.

——— (2019b): *RCAP: Assessment of the Basel Committee's large exposures framework – Brazil*, March.

——— (2019c): *RCAP: Assessment of the Basel Committee's large exposures framework – Canada*, July.

——— (2019d): *RCAP: Assessment of the Basel Committee's large exposures framework – Australia*, July.

——— (2019f): *RCAP: Assessment of Basel large exposures regulations – Argentina*, November.

——— (2019e): *RCAP: Assessment of the Basel Committee's large exposures framework – India*, July.

——— (2019f): *RCAP: Assessment of Basel large exposures regulations – Argentina*, November.

——— (2020a): *RCAP: Assessment of Basel large exposures regulations – Hong Kong SAR*, March.

——— (2020b): *RCAP: Assessment of Basel large exposures regulations – Indonesia*, March.

——— (2020c): *RCAP: Assessment of Basel large exposures regulations – Singapore*, March.

——— (2020d): *Standardised approach: credit risk mitigation*, March.

——— (2022a): *RCAP: Assessment of Basel Committee's large exposures framework – European Union*, July.

——— (2022b): *RCAP: Assessment of Basel Committee's large exposures framework – Japan*, September.

——— (2023a): *Large Exposures (LEX10 - LEX40)*, January.

——— (2023b): *RCAP: Assessment of Basel Committee's large exposures framework – South Africa*, April.

——— (2023c): *RCAP: Assessment of Basel Committee's large exposures framework – United States*, July.

——— (2023d): *CRE – Calculation of RWA for credit risk – CRE20*.

Board of Governors of the Federal Reserve (1933a): *Section 23A. Relations with affiliates*, June.

——— (1950): *Federal Deposit Insurance Act (12 U.S.C. 1828(j))*, September.

——— (1975): *Transactions with Affiliates - FR Y-8*, March.

—— (1994): *12 CFR Part 215 - Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (Regulation O)*, February.

—— (2002): *Regulation W, 12 CFR Part 223*, December.

—— (2018): *Single-counterparty credit limits for bank holding companies and foreign banking organizations*, August.

—— (2020a): *Single-Counterparty Credit Limits for Bank Holding Companies and Foreign Banking Organizations*, May.

—— (2020b): *Single-Counterparty Credit Limits Reporting Form-FR2590*, March.

Board Resolution of the Agency of the Republic of Kazakhstan for Regulation and Development of Financial Market (2021): no 68.

Credit Suisse (2021): *Credit Suisse Group Special Committee of the Board of Directors report on Archegos Capital Management*, July.

European Banking Authority:

—— (2013b): *Capital Requirements Regulation – Article 400*, June.

—— (2016) *EBA report on the review of the large exposures regime*, October.

—— (2017): *Final Guidelines on connected clients*, November.

—— (2018): *Large exposures – treatment of connected clients principle on exposures to other group entities outside prudential scope of consolidation*, December.

—— (2021): *Final Report on Guidelines on large exposures breaches and time and measures to return to compliance*, September.

—— (2022): *Final report on draft RTS on group of connected clients*, December.

European Central Bank (2013): *Regulation (EU) No 575/2013 if 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*, June.

—— (2017): *Imposition of administrative penalties on Banca Popolare di Vicenza S.p.A. in liquidazione coatta amministrativa*, August.

—— (2018): *Imposition of an administrative penalty on Novo Banco, SA*, December.

—— (2019a): *Imposition of an administrative penalty on Sberbank Europe AG*, February.

—— (2019b): *Sanction publication – 2019 – Natixis Wealth Management Luxembourg*, September.

—— (2022): *Supervisory methodology*, February.

Financial Services Authority (2010): *CP10/17: Strengthening Capital Standards 3 – feedback to CP09/29 final rules for CRD2, and further consultation*, July.

Financial Stability Board (FSB) (2022): *2022 List of Global Systemically Important Banks (G-SIBs)*, November.

French Prudential Supervision and Resolution Authority (2018a): *Decision n D-HCSF-2018-2*, May.

—— (2018b) : *HCSF 180511 - Notice Mesure Grands Risques*, May.

Monetary Authority of Singapore (2021): *MAS NOTICE 656 (AMENDMENT) 2021 – Exposures to single counterparty groups for banks incorporated in Singapore* (June), page 16.

Minister of Finance, Funds and Regional Policy of the Republic of Poland (2021): *“Regulation on the risk management system and internal control system and remuneration policy in banks”*, *Journal of Laws*, item 1045, June.

National Bank of the Republic of Kazakhstan (2017): "Rules on setting up norms and methodology of prudential norms evaluation, limits and capital requirements for banks", *Resolution of the Board of the National Bank of the Republic of Kazakhstan*, no 170 (with further amendments and annexes).

National Banking and Securities Commission (CNBV) (2023): *Banking Single Rule Book*, April.

Office of the Comptroller of the Currency (2013): *12 CFR Part 32 – Lending Limits*, June.

Office of the Superintendent of Financial Institutions (OSFI) (2019a): *Large Exposure Limits for Domestic Systemically Important Banks*, April.

——— (2019b): *Final Guideline B-2: Large Exposure Limits for D-SIBs*, April.

Polish Financial Supervision Authority (2016): "Recommendation C on concentration risk management, May", *Journal of Laws of the Polish Financial Supervision Authority*, July, item 15.

Prudential Authority of South Africa (2022a): *Directive 3 of 2022*, April.

——— (2022b): *Annexure 1 to LEX Directive*, April.

Saudi Arabian Monetary Authority (SAMA) (2019): *Large Exposure (LEX) Rules for Banks*, August.