INTERNATIONAL MONETARY FUND

IMF Country Report No. 24/182

LUXEMBOURG

FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2024

TECHNICAL NOTE ON SELECTED ISSUES IN BANKING SUPERVISION

This Technical Note on Selected Issues in Banking Supervision for the Luxembourg FSAP was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on January 2024.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

© 2024 International Monetary Fund

INTERNATIONAL MONETARY FUND

LUXEMBOURG

FINANCIAL SECTOR ASSESSMENT PROGRAM

May 20, 2024

TECHNICAL NOTE

SELECTED ISSUES IN BANKING SUPERVISION

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Luxembourg. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

CONTENTS

Glossary 3

EXECUTIVE SUMMARY 5

INTRODUCTION 8
A. Scope and Approach 8
B. Institutional Setting 8

SELECTED ISSUES 10
A. Governance and Operational Independence of the CSSF 10
B. Division of Supervisory Liquidity Responsibilities: BCL and CSSF 11
C. Liquidity Supervision of LSIs 13
D. Operational Risk and Resilience 14
E. Related Party Lending 16
F. Interest Rate Risk in the Banking Book (IRRBB) 17
G. Designation of CBL Direct Supervision by the ECB 18

PROGRESS ON 2017 FSAP RECOMMENDATIONS 18
A. Resources and Skills in Banking Supervision 20
B. Supervisory Approach 22
C. Interconnectedness with Foreign-Based Banking Parent Groups 22
D. Home-Host Relationships 25
E. Credit Risk 26
F. Regulation of Nonbank Holding Companies 27

TABLES

1. Main Recommendations 7
2. Total Assets by Type of Bank (end-June 2023) 9
3. Summary of Actions Taken by the Authorities to Address the 2017 FSAP Recommendations 18
4. CSSF Staff Numbers 21
5. CSSF Risk Expertise Staff Complement 21
6. CSSF Staff Turnover Figures 21
7. Timing of On-Site Inspection Reports 22

Glossary

MCM	Monetary and Capital Markets Department
ABBL	Bankers' Association of Luxembourg
ACA	Insurance Companies Association
ALFI	Luxembourg Association for the Funds' Industry
ALMM	Additional Liquidity Monitoring Metrics
AMA	Advanced Model Approach
AML/CFT	Anti-Money Laundering/Combatting the Financing of Terrorism
BCL	Central Bank of Luxembourg
BCP	Basel Core Principles for Effective Banking Supervision
BSD	Banks' Supervision Department
CAA	Commissariat aux Assurances
CBL	Clearstream Banking SA Luxembourg
CdRS	Systemic Risk Committee
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CSDR	Central Securities Depositories Regulation
CSSF	Commission for the Supervision of the Financial Sector
EBA	European Banking Authority
ECB	European Central Bank
EU	European Union
FICOD	EU Financial Conglomerates Directive
FGDL	Luxembourg Deposit Guarantee Fund
FINREP	EU Financial Reporting Framework
FMI	Financial Market Infrastructures
FSAP	Financial Sector Assessment Program
FTE	Full time equivalent
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
HQLA	High Quality Liquidity Assets
ICLAAP	Internal Capital and Liquidity Adequacy Assessment Process
ICSD	International Central Securities Depositary
IF	Investment Fund
IFRS	International Financial Reporting Standards

IRE	Institut des réviseurs d'entreprises (Industry Association of the audit profession)
LCR	Liquidity Coverage Ratio
LFS	Law on the Financial Sector
LSI	Less Significant Institution
LSREP	Liquidity Supervisory Review and Evaluation Process
JST	Joint Supervisory Team
MHFC	Mixed Financial Holding Companies
MoF	Ministry of Finance
MOU	Memorandum of Understanding
NCA	National Competent Authority
SI	Significant Institution
SSM	Single Supervisory Mechanism
SREP	Supervisory Review and Evaluation Process
TCB	Third Country Branch

EXECUTIVE SUMMARY

This review[1] examines specific aspects of the banking supervision regime in Luxembourg focusing on the supervision by the *Commission de Surveillance du Secteur Financier* (CSSF) of Less Significant Institutions (LSIs). In addition to updating the findings of the previous Technical Note of 2017, it examines the CSSF's supervisory approach to liquidity risk, interest rate risk in the banking book (IRRBB), operational risk, and related-party exposures.

The CSSF has made significant progress addressing the recommendations made in the 2017 FSAP.[2] The on-site inspection regime has been strengthened significantly. The timeline for completion of reports has been reduced, and additional staff has been recruited, expanding the depth and breadth of banking expertise. The monitoring of intragroup exposures and waiver compliance have been tightened significantly. The CSSF and BCL continue to monitor closely LSIs' sovereign debt and residential real estate exposures.

No material weaknesses were identified in the CSSF's supervisory processes in the areas of focus of the review—namely, LSI supervision of liquidity, IRRBB, operational risk, and related-party transactions. The CSSF follows SSM established SREP policies and procedures for these areas of supervision. Comprehensive and sufficiently regular data is collected in each area and the risk analysis performed was demonstrated to be detailed, supported by satisfactory IT systems. Horizontal supervision appears to be embedded effectively in supervisory processes.

Key gaps and vulnerabilities identified during this focused review are listed below. The main recommendations are in Table 1. While these are the primary recommendations to address key gaps, it is crucial to note that the report discusses various other findings and recommendations that should be considered comprehensively.

- As identified in the 2017 FSAP, government representation on the CSSF Board continues potentially to constrain the autonomy of the CSSF to set its own budget. Although the mission did not encounter any evidence of such interference, as structured, the Board has the potential to do so in future.

- Since the establishment of the SSM and in line with their respective legal responsibilities, the CSSF and the BCL have established principle-based working arrangements whereby the BCL performs the liquidity supervision of 19 LSIs, which includes the preparation of their Liquidity Supervisory Review and Evaluation Process (LSREP) to feed into the overall CSSF supervisory process. This arrangement, where a key element of supervision is not conducted by the National Competent Authority (NCA), is uncommon but has not proved ineffective as of the time of

[1] The review was carried out by Alan Ball, IMF external expert.

[2] Luxembourg: Financial Sector Assessment Program: Technical Note-Selected Issues in Banking Supervision (imf.org)

writing. However, the selection criteria for the group of 19 LSIs under direct BCL microprudential liquidity supervision should be further refined. In addition, the Memorandum of Understanding (MoU) between the BCL and the CSSF regarding the supervision of liquidity, although drafted, has not yet been signed.

- As the 2017 FSAP already pointed out, Clearstream Banking Luxembourg (CBL), an international central securities depository (ICSD), is defined by the SSM as a Less Significant Institution (LSI), and therefore under the direct supervision of the CSSF. However, CBL's global systemically important interconnectedness and substitutability characteristics, as well as its structural and operational complexity, may justify an ECB decision, on its own initiative or at the request of the CSSF, to take over the direct supervision of CBL as an LSI, pursuant to Article 6(5)(b) of the SSM Regulation, as implemented by Article 67(2)(b)-(d) and following of the SSM Regulatory Framework. The CSSF is therefore advised to request the ECB to take over direct supervision of CBL as an LSI according to the legislation governing the SSM.

- A Working Group including public and private sector participants and chaired by the BCL has been set up and tasked with analyzing the potential setting up of a credit register in Luxembourg. Progress has been delayed due to COVID-19, but the Working Group has produced a first draft report.

- Although no third country branch (TCB) in Luxembourg currently holds a material amount of retail deposits, which is in line with the current CSSF position regarding the retail activity of TCBs operating in Luxembourg, CSSF's current policies may not address adequately the potential future risks associated with the acceptance of retail deposits by TCBs in Luxembourg.

Table 1. Luxembourg: Main Recommendations		
Recommendations and Authority Responsible for Implementation	**Priority[1/]**	**Urgency**
Safeguard the independence of the CSSF board members through changing the law. In cases where legal amendments are not feasible, consider issuing subsidiary legislation to establish procedural safeguards to the extent feasible within the constraints provided under the law.	Medium	Near Term
The BCL and CSSF should finalize the MoU on responsibilities for bank liquidity supervision.	High	Near Term
The BCL and CSSF should clarify the criteria used to determine the set of LSIs to be supervised for liquidity purposes by the BCL. The arrangement whereby the BCL undertakes the LSREP assessment for a group of LSIs should be kept regularly under review.	Medium	Near Term
The BCL should ensure that all parties on the Working Group actively pursue the developmental work on setting up a credit register with clear deadlines set.	High	Medium Term
The CSSF should make further representation to justify ECB's direct CBL supervision as an LSI based on the SSM Regulatory Framework.	High	Near Term
[1/] Near term: < 12 months; Medium term: 12 to 24 months.		

INTRODUCTION

A. Scope and Approach

1. The review focused on specific aspects of the current Luxembourg banking supervisory regime relating to Less Significant Institutions (LSIs) and followed up on the recommendations arising from the 2017 FSAP. The review involved detailed discussions with the CSSF and BCL. There were separate meetings with the Luxembourg Ministry of Finance (MoF), three Luxembourg banks, and other private sector participants. Scoping meetings were held with both the BCL and the CSSF between May 11–17, 2023 and on June 16, 2023. The on-site mission was held in Luxembourg between October 4–18, 2023.

2. The review used the 2012 version of the "Basel Core Principles for Effective Banking Supervision" (BCP) as the reference to assess specific aspects of the CSSF supervisory framework, but the review does not involve a formal BCP assessment. The specific areas considered in the review covered the CSSF's supervisory approach to liquidity, including the division of liquidity responsibilities between the BCL and CSSF, interest rate risk in the banking book (IRRBB), operational risk and related party lending. The follow-up work on the recommendations in the 2017 FSAP included the supervision of intragroup exposures, adequacy of supervisory resources within the CSSF, the effectiveness of the on-site inspection regime, home/host supervision arrangements and areas where operational independence of the CSSF departs from the BCPs. The mission also sought clarification of the rationale for the designation of CBL as an LSI.

3. The mission would like to thank the CSSF and BCL staff for the excellent preparatory work and their openness, cooperation, and hospitality throughout the review.

B. Institutional Setting

4. The CSSF is responsible for the prudential supervision of Luxembourg's financial sector except for significant credit institutions (SIs), which are the direct responsibility of the ECB, and insurance undertakings, which are the responsibility of the Commissariat aux Assurances (CAA). Accordingly, besides banks, the CSSF also supervises investment firms, investment funds, securities markets, payment institutions and the audit profession. Under the oversight of the European Central Bank (ECB), the CSSF has supervisory responsibility for 62 LSIs, with liquidity supervision for 19 of those LSIs undertaken by the BCL (see below), and 13 third country branches.

5. There are three executive bodies within the CSSF—the Executive Board, the Resolution Board and the Depositor and Investor Protection Board. The Executive Board is the highest executive authority in the CSSF for all matters other than resolution and depositor and investor protection. It consists of a Director General and four other directors. Above the Executive Board is the Board, the composition, and powers of which are discussed below. The Resolution Board is the decision-making body within the CSSF on bank resolution matters (i.e., to make decisions regarding the failure or likely failure of LSIs). The Depositor and Investment Protection Board is the body responsible for the carrying out of deposit and investor protection functions.

6. As of June 30, 2023, there were 120 banks operating in Luxembourg, with 45 classified as SIs, 62 as LSIs, and 13 as third country branches (TCBs). Among these banks, there were 8 domestically owned institutions, 67 subsidiaries, and 45 branches. Foreign-owned banks dominate the sector, accounting for 92 percent of total bank assets (see Table 2). Subsidiaries and branches of foreign banks domiciled in Luxembourg play a central role in intragroup liquidity management and custodial operations for Luxembourg-domiciled investment funds. Additionally, a small number of banks serve the domestic economy and are also involved in private banking for high net-worth individuals. In terms of the broader banking landscape, there is a wide range of business activities undertaken by banks in Luxembourg, as depicted in Table 2, which represents the distribution of assets per business, distinguished by legal form and business model.

Table 2. Luxembourg: Total Assets by Type of Bank (end-June 2023)

Number of banks		Type of Bank	Total assets for 2023Q1 (in €bill)
By SSM supervisory status			
45		Significant Institutions	636.107
62		Less Significant Institutions	173.604
13		Third Country Branches	102.406
By legal form			
67		Foreign owned – subsidiary	467.807
45		Foreign owned – branch	369.423
8		Domestically owned	74.897
By business model			
27		Custodian banking	250.779
5		Universal banking	213.455
37		Corporate finance	198.850
33		Private banking	156.395
8		Clearing, treasury and-or payment services	55.434
8		Retail and commercial banking	22.774
2		Covered bonds banking	14.440

Source: CSSF

7. The financial sector in Luxembourg has continued to grow since the 2017 FSAP and plays key domestic and global roles. The growth has been driven mainly by the investment fund sector, the second largest in the world and 78 times Gross Domestic Product (GDP). Bank assets (Table 2) have remained steady at 13 times GDP since 2017. Only a fifth of banking assets engage in commercial banking activities, with Luxembourg households borrowing almost exclusively from banks. A large share of bank assets is in private banking and fund management activities. Among the LSIs is CBL, one of the world's largest ICSD. It is prudentially supervised by the CSSF as an LSI and overseen by the BCL as a securities settlement system operated by CBL, which is a financial market infrastructure (FMI). CBL's classification as an LSI is discussed below.

8. The financial sector has adjusted well to the high inflationary environment amid the Ukraine War in 2022. The Common Equity Tier 1 (CET1) capital ratio increased to 23.1 percent in 2022 as higher net interest income and lower operating costs helped offset rising loan loss provisions and valuation losses in the bond portfolio. Even though non-performing loans are only 1 percent of gross loans, stage 2 loans continue to rise following the forbearance afforded during the pandemic and the

bleak economic outlook after the beginning of the Russian war in Ukraine. The forbearance measures have since been withdrawn. Redemptions from investment funds have been manageable so far, with the sector's deposits in banks falling slightly while maintaining banks' liquidity coverage ratio (LCR) around 150 percent.

9. Luxembourg, as a founding Member State of the EU, the wider European Economic Area, and the Euro area, has incorporated European directives to regulate financial services. This includes the implementation of International Financial Reporting Standards (IFRS) for prudential reports in compliance with EU rules. Local Generally Accepted Accounting Principles (GAAP) are used for preparing annual statutory accounts, and the CSSF oversees the audit profession, approving statutory auditors and audit firms. The legal system in Luxembourg is based on the civil law, with many laws influenced by French and Belgian legislation. Most legislation is the result of EU regulations, directives, and decisions, and the country has a well-established system of business laws, which provide adequate mechanisms for the fair resolution of disputes. The judicial system is regarded as independent and efficient.

SELECTED ISSUES

A. Governance and Operational Independence of the CSSF

10. The BCPs recommend that the supervisor is financed in a manner that does not undermine its autonomy and, more broadly, that no government or industry interference should compromise its independence. The 2017 FSAP noted that there was no evidence that the prevailing governance structure of the CSSF constrained its operational independence, but that the structure gave rise to the potential for future Ministerial or outside interference. It recommended that the authorities consider a structure whereby:

- The financial supervisor would no longer fall under the direct authority of the minister but would be answerable to Parliament.
- The board comprise independent directors.
- The board is in a position to determine its own budget.

11. Since the 2017 FSAP, the overall CSSF governance structure has remained unchanged. The CSSF Board is composed of seven members appointed by the Grand Duke on a proposal from the Government in Council. A majority of four members are appointed representatives of the Ministry of Finance (MoF) and three members are appointed as representatives of regulated sectors; currently, the Chairman of the Bankers' Association of Luxembourg (ABBL), the Director General of Luxembourg Association for the Funds' Industry (ALFI), and a representative from the Institut des réviseurs d'entreprises (IRE), the industry association of the audit profession. The Executive Board is the CSSF's highest executive authority, comprising a director-general and two to four directors, all nominated by the Grand Duke on a proposal by the government for a renewable five-year term. The Executive Board currently has five members.

12. Despite there being no current evidence of the governance structure constraining operational independence, the legal composition of the CSSF board could give rise to questions about its independence and compliance with international standards. The government's majority and the presence of industry representatives on the board introduces the potential for government or industry interference. The Board has no power to intervene, directly or indirectly, on prudential or supervisory matters or on the day-to-day management of the CSSF. These remain the preserve of the Executive Board. Sound international practices call for independent boards composed primarily of unaffiliated members. As recommended in the 2017 FSAP, the situation demands changes in the law. However, if such legal changes are not feasible, the authorities should establish procedural safeguards through subsidiary legislation, although this would not be the first best solution. To the extent feasible within the constraints provided under the law, the secondary legislation will define clear roles for the board and executive board in the existing two-tier structure and develop criteria particularly regarding government actions related to budget proposals, board member nominations and dismissals. The importance of introducing such permanent safeguards, to the extent feasible within the constraints provided under the law, is emphasized to future-proof against undue pressures.

13. Recommendation:

- Safeguard the independence of CSSF board members through changing the law. In cases where legal amendments are not feasible, consider issuing subsidiary legislation to establish procedural safeguards to the extent feasible within the constraints provided under the law.

B. Division of Supervisory Liquidity Responsibilities: BCL and CSSF

14. Following the entry into force of Regulation (EU) No 1024/2013 (SSM Regulation) and the entry into force of the SSM, the ECB assumed the role of the central supervisory authority responsible for the direct supervision of SIs and indirect supervision of LSIs. While the CSSF was designated as the Luxembourg NCA as per CRR/CRD, the BCL has responsibility under its organic law for "supervising the general liquidity situation on the markets as well as for assessing market operators in this regard."[3] BCL Regulation 2009/No. 4 of April 29, 2009 on liquidity supervision provided guidance on the BCL's approach to liquidity supervision.[4] Article 2 of the Regulation specified that "*The Central Bank's supervision of market participants is mainly aimed at credit institutions that are monetary policy counterparties. It may apply, on a case-by-case basis, to other operators listed in Article 2(1) of this Regulation to the extent that their activity is likely to have a significant impact on the liquidity position of credit institutions, on the general liquidity situation of the markets or on the proper conduct of monetary policy operations*." According to Article 2.9. of the SSM Framework Regulation, the BCL may also carry out supervisory tasks within the framework set out in national law and the SSM Framework Regulation.

[3] http://legilux.public.lu/eli/etat/leg/loi/1998/12/23/n1/jo

[4] Official Journal of the Grand Duchy of Luxembourg (public.lu)

15. In line with their respective legal responsibilities and the SSM Framework Regulation, the BCL and CSSF have established principle-based working arrangements at an operational level regarding their shared responsibilities for liquidity supervision of banks. These working arrangements were established at the inception of the SSM to strengthen the liquidity supervision of Luxembourg LSIs. The 2017 FSAP recommended that the CSSF and BCL should consider entering into an MoU to formalize these working arrangements. A draft MoU has since been prepared. It should be finalized and signed as a matter of priority. The main provisions of the MoU include:

- Clarification of the participation of the BCL in Joint Supervisory Teams (JSTs) and in on-site inspections of SIs organized by the ECB.
- The specific topics regarding cooperation and division of work between the BCL and CSSF in respect of liquidity supervision of LSIs.
- Co-operation between the BCL and CSSF in cases of liquidity crisis.
- Representation and co-ordination in European and international working groups.
- Consultation on new regulations and circulars.
- Cooperation regarding liquidity stress tests.

16. The BCL and CSSF participate together in JSTs on the supervision of SIs to ensure the effective ongoing supervision of liquidity risk. The BCL participates in the JSTs of eight banking groups (all banking groups headquartered in Luxembourg under the direct supervision of the ECB, as well as selected banking groups headquartered elsewhere in the Euro area with important subsidiaries in Luxembourg). As part of the cooperation and collaboration between the two authorities in the supervisory process, the liquidity data submitted by all banks is made available to both BCL and CSSF. Further exchanges of information regarding individual institutions occur on an ad-hoc basis, and more specifically in the context of potential crisis situations.

17. In line with the principle-based working arrangements agreed between CSSF and BCL in 2015, the BCL also has responsibility for the ongoing liquidity supervision of 19 LSIs and 10 third country branches (TCBs). This arrangement, whereby an element of the overall supervision of a bank is undertaken by an authority other than a National Competent Authority (i.e., the CSSF), is uncommon but has not proved ineffective as of the time of writing. When the arrangement was set up in 2015, the main criterion for deciding the set of banks to fall under the supervisory remit for liquidity of the BCL was based primarily on size. The ECB classification criteria for SIs and LSIs does not reflect the composition of the banking sector in terms of importance and materiality for Luxembourg. Therefore, the allocation of banks under the BCL remit does not include all SIs under the ECB classification and, by contrast, it contains a number of banks designated as LSIs under the ECB classification for liquidity purposes. There have been minor changes to the composition of the population of LSIs supervised by the BCL since 2015, but these have not been based on specified

criteria, but driven primarily by structural changes (i.e., conversion of a subsidiary to a branch). The BCL and CSSF should further specify the criteria for LSIs to be supervised by the BCL and review the group periodically.

18. As part of its ongoing liquidity supervision of the specified group of LSIs, the BCL also undertakes the annual Liquidity SREP (LSREP) assessment of those banks. When completed, the LSREP is shared with the CSSF and integrated into the overall SREP assessment of the respective bank. As regards LSIs, the BCL issues qualitative recommendations where weaknesses are identified and follows-up on any remediation work, while regulatory exemptions and quantitative add-ons on regulatory liquidity requirements are issued by the CSSF following consultation with the BCL, since the CSSF remains the responsible authority.

19. Although it is not common across jurisdictions for an element of a bank's supervision to be conducted outside the NCA, the arrangement is currently effective in practice. The BCL is adequately resourced in terms of staff and depth of experience to undertake liquidity supervision of the group of LSIs in question, and co-ordination between the two authorities appears effective. The BCL also benefits significantly from gaining a detailed understanding of the banks' liquidity operations through its supervisory activities, which helps promote its statutory requirement to monitor the general liquidity situation of the markets. The authorities should, however, keep under review the BCL's role of performing the LSREP for the specified group of LSIs to ensure that it continues to promote the effective overall supervision of the banks concerned. The authorities should also further specify the criteria used to determine the set of LSIs to be supervised for liquidity purposes by the BCL.

20. Recommendations:

- The BCL and CSSF should finalize the MoU as a matter of priority.
- The BCL and CSSF should keep under review the arrangement whereby the BCL undertakes the LSREP assessment for a group of LSIs. Regular review should be incorporated in the MoU to be signed by the two authorities.
- The authorities should further specify the criteria used to determine the set of LSIs to be supervised for liquidity purposes by the BCL.

C. Liquidity Supervision of LSIs

21. The approach to liquidity supervision of LSIs is comprehensive. The legislative and regulatory framework for liquidity supervision of LSIs is set by the EU, with such institutions being subject to the Liquidity Coverage Ratio (LCR) in accordance with the Capital Requirements Regulation (CRR) and the LCR Delegated Act (LCRDA) and to the Net Stable funding Ratio (NSFR) in the CRR. The CSSF has aligned its supervisory approach with that of the ECB, which has been formalized through Circular CSSF 22/816 and the CSSF Regulation 18–03, as amended. The qualitative requirements for LSIs to maintain a sound liquidity risk management framework are set

out in the Law on the Financial Sector (LFS) (Article 53–22), and further specified in CSSF Circulars 12/552 and 09/403.[5,6] Assessment of the liquidity risk management framework is performed during the SREP according to Chapter 10 of the Single Supervisory Mechanism (SSM) LSI SREP Methodology, which accords with the relevant European Banking Authority's (EBA) SREP guidelines (EBA/GL/2022/03).

22. The overall liquidity position of Luxembourg LSIs is comfortable and has not been a general supervisory priority in recent years. At end-June 2023, the CSSF reports an average LCR for all LSIs at 230 percent, with total Level 1 assets representing 97 percent of high-quality liquid assets. Similarly, the average NSFR ratio for LSIs at end-June 2023 stood at 210 percent. Neither the CSSF nor BCL have conducted an on-site liquidity inspection of LSIs over the past five years, but one is scheduled to take place by early 2024. This review was triggered by a weak SREP score for risk control within the LSI.

23. Bank liquidity and funding profiles are assessed by line-supervision on an on-going basis through analysis of prudential data and other information. In addition to regular LCR and NSFR data, the CSSF and BCL also receive a monthly Additional Liquidity Monitoring Metrics (ALMM) report and quarterly data on asset encumbrance. The Internal Capital and Liquidity Adequacy Assessment Process (ICLAAP) submission is received annually from LSIs and formally assessed during the annual SREP process. During the annual SREP process, this information is condensed in a formal assessment. In the past three years, the qualitative recommendations on liquidity issued by the BCL/CSSF have focused mainly on weaknesses detected in the stress testing frameworks of LSIs, intraday liquidity risk management, the risk appetite of such banks and on weaknesses in contingency funding plans. As noted earlier, the qualitative recommendations are issued by the BCL on those LSIs for which it has liquidity supervisory responsibility. In terms of quantitative measures, the CSSF imposed higher outflow factors on short term Private Banking deposits at two different banks in 2022. While the first measure was taken in accordance with Article 25(3) of the LCRDA in the course of the on-going supervision, the second measure was imposed as a Pillar 2 measure in accordance with Article 53–5 of the LFS.

D. Operational Risk and Resilience

24. The CRR sets the quantitative framework for LSIs to maintain a certain amount of capital to protect against operational risks and the CRD sets the operational risk management requirements. The CRD was transposed into law by the LFS. The LFS establishes general principles for governance, internal controls, and risk management, which form the essential elements of operational risk management, and includes dedicated provisions on operational risk in line with CRD. The LFS sets requirements for LSIs to have a robust governance framework with clearly defined roles and responsibilities for the management and oversight of all types of risks, including operational risk. The LFS also requires banks to have effective internal control systems, including risk

[5] Law of 5 April 1993 on the financial sector, as amended (cssf.lu)

[6] Circular CSSF 09/403

management systems to identify, assess, monitor, and control operational risks. More specifically, LSF Article 53–21 requires CRR institutions to implement policies and processes to evaluate and manage their exposure to operational risk, including model risk, and to cover low-frequency high-severity events, as well as contingency and business continuity plans to ensure the CRR institution's ability to limit losses and operate on an ongoing basis in the event of severe business disruption.

25. Ongoing supervision of operational risk within LSIs forms an integral part of the broader SREP of each LSI. Operational risks are assessed on an on-going basis by line supervisors for all LSIs and third country branches. The assessment includes a quarterly monitoring of defined financial and non-financial key indicators to detect material changes in the financial conditions and risk profiles in line with EBA guidelines.[7] Qualitative information on operational risk is provided in the Long Form Report (LFR) submitted annually by each LSI. The depth and intensity of the analysis is proportionate to the risk profile and/or the complexity of the bank. This quarterly analysis involves a quantitative assessment of the main risk factors to which LSIs are exposed and is based on analysis of variations observed in the prudential reporting and predefined Key Risk Indicators (KRIs). Horizontal analysis is also made available by other divisions/departments. A horizontal operational risk review is conducted to determine the level of operational risk at sector level and to provide line supervisors with benchmarks and indicators across credit institutions on the level of operational risk capital requirements and loss experience. The CSSF does not have dedicated experts specifically in operational risk but has sufficient expertise in the various components of operational risk (i.e., governance, IT, depository banks, AML, outsourcing, etc.) to conduct on-site inspections when required.

26. Guidance on operational resilience requirements for LSIs remains work in progress as European-wide policy work in this area evolves. Given the greater emphasis placed on ensuring operational resilience within banks at an international regulatory level, the CSSF should remain fully engaged at a European level to monitor developments on operational resilience requirements and fully incorporate them into their regulatory framework when finalized.

27. CBL, a systemically important ICSD, has a business model that has inherently high operational risk. The CSSF has a dedicated team of four experienced supervisors supervising CBL and the BCL has two full time equivalents (FTEs) for its oversight responsibilities for CBL.

28. The supervision of CBL by the CSSF and BCL is intensive. CSSF and BCL staff are in contact most days with CBL to discuss issues as they arise. In addition to the normal suite of regulatory reports required under the CRR and CRD, CBL provides a range of additional reports required under the Central Securities Depositories Regulation (CSDR). Specifically in respect of operational risk there are, among others, reports on performance of the Securities Settlement System, business continuity testing, manual interventions, and in particular, on operational incidents. The coordination and collaboration between the BCL and CSSF on CBL appear effective.

---

[7] EBA/GL/2014/13, Title 3 Monitoring of key indicators.

29. Recommendations:

- Given the greater emphasis placed on ensuring operational resilience within banks at an international regulatory level, the CSSF should remain fully engaged at a European-level to monitor developments on operational risk requirements and fully incorporate them into their regulatory framework when finalized.

E. Related Party Lending

30. The definition of "related party" is set out in Circular CSSF 12/552 (Part I Chapter 1) and the definition of "related party transaction" is set out in the self-assessment questionnaire that is sent out annually to all banks. Although both definitions are consistent with the BCBS definitions, the related party transaction definition should be given public prominence and set out transparently in a Circular.

31. The monitoring of related party transactions within LSIs is undertaken through a combination of off-site data analysis and on-site inspections. The CSSF receives quantitative data on a bank's related party lending through semi-annual European Banking Authority's Financial Reporting (FINREP reports) and quarterly large exposure reports. Intragroup data are also available from the monthly submission of the LCR and Additional Liquidity Monitoring Metrics (ALMM) reports. The primary source of qualitative information on related party lending is provided in the long form report (LFR), which is submitted annually by all banks. The LFR provides a description of an LSI's policies and processes in place to manage the risks around related party transactions, including management of any conflicts of interest. It also provides the LSI's related party transactions risk assessment, including any exceptions that had arisen during the year; confirmation that all transactions with related parties are undertaken at arm's length's basis; the LSI's transfer pricing methodology and its governance arrangements around monitoring related party exposures. The LFR also provides quantitative information on related parties' on- and off-balance sheet exposures, including guarantees, and profit and loss data on related party exposures.

32. During on-site inspections, the CSSF examines an LSI's policies, procedures, and documents related to related party lending. This includes reviews of outsourcing arrangements, conflict of interest management and, where relevant, the existence of a transfer pricing policy. On-site credit review inspections always assess an LSI's group of connected clients via samples of credit files. Since 2017, the CSSF has conducted eleven on-site inspections which have involved reviews of exposures to group entities, and one on-site inspection reviewing conflicts of interests for transactions with the bank's shareholder. A review of the data submitted in the LFR and from an on-site review demonstrated that the CSSF 's supervisory approach to identifying and managing risks arising from related-party exposures is appropriate.

33. Recommendation

- The definition of "related party transaction" should be disclosed publicly in a Circular.

F. Interest Rate Risk in the Banking Book (IRRBB)

34. The CSSF approach to supervising interest rate risk in the banking book of LSIs is effective. The legal and regulatory framework is set by the relevant EU legislation and by Article 53 of the LFS, with additional guidance provided in Chapter 8 of Circular 12/552. The CSSF follows the SSM SREP methodology for LSIs for the assessment and rating of a bank's risk exposure, identification, evaluation, management, and mitigation of IRRBB and IRRBB stress testing. The quantitative assessment of the supervisory outlier tests is based on the eight standard interest rate shock scenarios for the EVE metric and the two parallel shift scenarios for the NII metric, and some data fields and questions regarding the main risk drivers (i.e., currencies, optionality, non-maturity deposit (NMD). Outlier banks are required to respond to an additional set of both qualitative and quantitative questions. Relevant data are collected on a timely basis in line with standard SSM reporting requirements. Additional information is collected from FINREP data regarding valuation of assets and liabilities, hedges and profit and loss accounts (i.e., interest rate margin, other comprehensive income, etc.). Banks also report the EVE and NII metrics of the Supervisory Outlier tests defined in Circular CSSF 08/338 to the CSSF once a year under eight different interest rate scenarios for EVE, and two interest rate scenarios for NII. Furthermore, LU banks are requested to calculate the impact of interest rate shocks on their NII and EVE quarterly and immediately report to the CSSF whenever the worst EVE exceeds 15 percent of a bank's T1 capital.

35. Regular analyses of bond and equity portfolios are undertaken. In March 2023, the CSSF undertook an interest rate sensitivity analysis on the amortized cost and mark-to-market bond portfolios of all banks. The scenario involved a 200-bps shock to assess the impact on valuation losses on both portfolios. The review concluded that net exposures remained minimal and manageable given hedging arrangements in the banks concerned. Follow-up work on the most impacted banks was conducted by line supervisors as part of on-going supervision. At end June 2023, bonds in the mark-to-market portfolio of all banks stood at EUR32 billion, which represented 3 percent of banking sector assets. Bonds in the amortized portfolio stood at EUR 88 billion, representing 9 percent of total banking assets. The gross valuation losses and solvency implications (without hedges) of the 200-bps interest rate shock scenario were EUR 1.4 billion in the mark-to-market portfolio and EUR 3.3 billion in the amortized cost bond portfolio (banks with solvency requirements only). The CSSF judged these potential losses to be limited and manageable. In line with the general add-on policy based on the overall SREP score, the CSSF has not applied specific Pillar 2 capital add-ons in respect of IRRBB on any bank to date.

36. The CSSF is adequately resourced to conduct on-site IRRBB inspections. It has six members of staff with knowledge of IRRBB, ranging from entry to advanced skills. Five on-site IRRBB inspections have been conducted on LSIs in the past five years. A file review confirmed the thoroughness of the on-site process and its output. The authority has required banks to undertake a number of corrective actions in relation to IRRBB in the recent past, including review of internal NMD models used and the documentation supporting the models; review of internal risk limits and forward-looking stress tests/ICAAP stress tests to ensure they are commensurate and proportionate to the business model and risks; review of stress test calculation and aggregation of different currencies; and review of risk appetite, KRIs, early warning indicators and risk limits used by banks.

G. Designation of CBL Direct Supervision by the ECB

37. Under the EU legal framework, the particular supervisory challenges posed by the CBL could justify, by way of exception to the default distribution of competences between the ECB and the NCAs, the ECB's takeover of the direct supervision of CBL as an LSI. As a globally important FMI, CBL has systemic relevance both at a local and at an international level. In particular, its interconnectedness and its substitutability characteristics as well as its structural and operational complexity, make it necessary to ensure consistent application of high supervisory and justify an ECB decision to take over the direct supervision of this LSI, pursuant to Article 6(5)(b) of the SSM Regulation, as implemented by Article 67(2)(b)-(d) of the SSM Framework Regulation.

38. Notwithstanding the effective supervision at the national level, there is a case for the CBL to be directly supervised by the ECB. A takeover of direct supervision of an LSI by the ECB amounts to a decision of derogation (departing from the ordinary allocation of responsibilities between the ECB and the NCAs) adopted by way of exception, and, as such, it is subject to an enhanced duty to state reasons. The takeover may either be decided by the ECB on its own initiative (after consulting with the CSSF) or requested to the ECB by the CSSF under Article 6(5)(b) SSMR, as implemented by Article 68 of the Framework Regulation. Provided that the CSSF can present the necessary and sufficient justification for deviating from the default rule, the ECB's takeover of direct supervision is justified, despite CBL being an LSI.[8]

39. Recommendation:

- The CSSF should make further representation to justify ECB's direct CBL supervision as an LSI.

PROGRESS ON 2017 FSAP RECOMMENDATIONS

40. The CSSF has made considerable progress in responding to the recommendations in the 2017 FSAP. Table 3 sets out the recommendations made in 2017 and a summary of the actions taken by the CSSF to address the issues raised. Actions taken are further discussed in this section.

Table 3. Luxembourg: Summary of Actions Taken by the Authorities to Address the 2017 FSAP Recommendations

Recommendation	Action Taken
Introduce a governance structure for the CSSF that would remove any potential for interference from the government or industry as is required under BCP 2.	No changes have been made to the governance structure of the CSSF.
Broaden the specific supervisory regime for intragroup exposures designed to limit the risks arising from such exposures that is	The CSSF's internal procedure goes further than the relevant ECB Regulation and Guideline 2017/697 on options and discretions by

[8] See Report of the Commission on the SSM of 11.10.2017 COM(2017) 591 final, at LexUriServ.do (europa.eu), page 7. This further confirmed by the SSM Supervisory Manual (europa.eu), page 5.

Table 3. Luxembourg: Summary of Actions Taken by the Authorities to Address the 2017 FSAP Recommendations (Continued)	
Recommendation	**Action Taken**
fully consistent with the ECB Regulation and Guideline resulting from the work on Options and Discretions.	considering the home country's resolution regime and assessing the bail-in risk of intragroup exposures.
Continue to strengthen the on-site inspection regime through the recruitment of additional staff.	The on-site inspections (OSI) Team has continued to recruit staff since 2017 with the current headcount of approx. 80 FTE.
Review the adequacy of banking risk experts in the Banking Supervision Department.	The CSSF has increased the number of risk experts available for on-site inspections significantly since 2017.
Reduce timeframe for completion of on-site inspection reports.	The timeline of completion of on-site inspection reports has been reduced significantly since 2017 to less than 3 months on average.
Increase frequency of on-site inspections of subsidiaries of Significant Institutions.	This is an issue for the SSM, not the CSSF.
Continue to monitor very closely any potential impact on banks from rising residential real estate prices.	The BCL and the CSSF carefully monitor developments in the real estate market and update the Systemic Risk Committee (CdRS) accordingly. The CSSF conducts at least quarterly assessments of RRE developments, including the monitoring of house prices, mortgage credit and other relevant indicators. The CSSF has also issued Circular CSSF 18/703 on the introduction of a semi-annual reporting of borrower-related residential real estate indicators, which are particularly relevant to follow-up on RRE-related vulnerabilities, credit standards and household indebtedness issues. The data and related analysis are discussed regularly at the CdRS. The CSSF also undertakes a regular deep dive analysis on household indebtedness and stresses the impact of increased defaults and price decline on bank capital.
Harmonize information submitted by banks on loan-to-value and debt-to-income ratios.	Harmonized definitions for the LTV, DTI and DSTI ratios are included in Circular 18/703, following the ESRB's recommendation ESRB/2016/14.
Work closely with ECB to include households in its credit bureau initiative.	The CdRS has set up a working group, including the CSSF, tasked with analyzing the potential setting up of a credit registry in Luxembourg. Work on the project continues.
Complete MOU with BCL on liquidity supervision regarding LSIs.	A draft MoU between the BCL and CSSF on respective responsibilities for liquidity supervision has been drafted but not yet signed.

Table 3. Luxembourg: Summary of Actions Taken by the Authorities to Address the 2017 FSAP Recommendations (Concluded)

Recommendation	Action Taken
Where warranted and in keeping with the provisions of Core Principle 11—Corrective actions—impose monetary fines commensurate with the breach in question.	In line with EU Directives, Luxembourg law provides for new and up-to-date methods of determining the amount of pecuniary sanctions that are now fully applied by the CSSF.
Ensure close interaction with supervisors of parents of Luxembourg banks located outside the euro area.	CSSF actively engages with foreign supervisors of Luxembourg banks outside the Euro area, through MoUs, joint supervisory teams, and supervisory colleges.
Continue to monitor closely banks' holding of sovereign debt.	The CSSF's Macroprudential Division monitors banks' holdings of sovereign debt closely in various forms including through its annual banking sector solvency stress test, analysis of weekly rating developments and semi-annual market risk monitoring. Sovereign debt holdings are also considered in routine off-site and on-site supervision.
In line with the recommendations of the 2016 Article IV Staff Report, the authorities should advocate for stronger oversight at the European level of nonbank holding companies that include banks.	Stronger oversight was established on 7 June 2019 with the publication of Directive (EU) 2019/878 amending Directive 2013/36/EU (CRD), which introduced new approval and oversight powers relating to financial holding companies and mixed financial holding companies.

A. Resources and Skills in Banking Supervision

41. While noting that there had been a significant increase in overall staffing numbers since the previous BCP assessment, the 2017 FSAP recommended that the CSSF continue to strengthen the on-site inspection regime through the recruitment of additional staff. Table 4 sets out the staffing complement of the CSSF's banking supervisory departments over the past five years, which demonstrate continued growth over that period from 173 Full Time Equivalents (FTE) to 221 FTE at end-year 2022. For the on-site inspection department, the growth is significant between 2017 and 2018 (+13 FTE).

42. Within the overall increase in the staffing complement, the CSSF on-site inspection team has continued to recruit staff with its current complement standing at 80 FTE. Most of this staff is in the On-site inspection department. Table 5 sets out the current complement of staff with specific risk expertise for the conduct of on-site supervision.

Table 4. Luxembourg: CSSF Staff Numbers

		2018		2019		2020		2021		2022	
	FTE at 31/12/2017	FTE at 31/12/2018	Change compared to 2017	FTE at 31/12/2019	Change compared to 2018	FTE at 31/12/2020	Change compared to 2019	FTE at 31/12/2021	Change compared to 2020	FTE at 31/12/2022	Change compared to 2021
Banking department	83,95	87,80	3,85	97,35	9,55	96,15	-1,20	125,85	29,70	129,45	3,60
On-site inspection (OSI) department	57,85	71,10	13,25	75,70	4,60	73,15	-2,55	71,60	-1,55	72,35	0,75
Departments PSF-SU (divisions) SU.S.I.	12,80	14,80	2,00	16,00	1,20	18,00	2,00	17,50	-0,50	19,20	1,70
	Total	**173,70**	**19,10**	**189,05**	**15,35**	**187,30**	**-1,75**	**214,95**	**27,65**	**221,00**	**6,05**

Source: CSSF. Note—not all staff within the OSI department are dedicated to banking supervision.

Table 5. Luxembourg: CSSF Risk Expertise Staff Complement

Specialty	Number of Managers	Number of agents	Total FTEs on CSSF supervised banks	off-site / on-site
[All areas]	1	6	2,17	on-site
AML	2	18	5,65	on-site
Banking risks	1	13	6,10	on-site
Corporate governance & Business model	1	14	4,65	on-site
Market risk, credit risk, IMI	1	4	1,18	on-site (mostly) + off-site
Depositary banks	1	7	2,25	on-site
IT risks	3	7	2,50	on-site & off-site
MIFID	1	5	1,18	on-site
Interest rate risk, own funds		1	0,39	on-site + off-site
Liquidity		1	0,39	on-site + off-site
Liquidity, own funds		1	0,39	on-site + off-site

Source: CSSF

Table 6. Luxembourg: CSSF Staff Turnover Figures

	Turnover figures for CSSF[1/]				
	2018	**2019**	**2020**	**2021**	**2022**
Banking department	3,49	6,48	2,07	7,21	3,13
On-site inspection department	4,65	6,81	6,72	4,15	2,78

[1/] Turnover is calculated using the formula: number of exits over a specific period, divided by the average number of employees over that same period (number of employees at the beginning + number of employees at the end, divided by 2). The number of employees is given in FTEs, but the number of exits is a headcount.

Source: CSSF

43. In line with the findings of the 2017 FSAP, staff turnover at the CSSF remains very low. Table 6 sets out the turnover figures for the past five years. Salaries in the CSSF are very competitive with the market and job security is an additional attraction.

44. The CSSF has made significant progress since 2017 to increase its staffing resources, both in terms of absolute numbers and in terms of breadth of knowledge. The CSSF appears adequately resourced to perform its current supervisory functions.

B. Supervisory Approach

45. The 2017 FSAP noted that the average time between the closing meeting of an on-site inspection with a bank and the communications of findings was six months, which was considered too long. Since 2017, the CSSF has reduced the timing between closing meeting and submitting the final recommendations to a bank to less than three months on average. Table 7 provides a breakdown of the timetable by type of on-site report.

Table 7. Luxembourg: Timing of On-Site Inspection Reports

Question 12 - Average Time for sending results in months (between closing meeting and letter)	2020	2021	2022	2023	Grand Total
For credit risk, IRRBB, oper	2,8	2,5	3,7		3,0
For IT risk					2,2
For Governance	4,8	3,5	2,3		3,5
For Business Model & Profitability	3,5	2,1			2,8
For Remuneration	1,3				1,3
Average time for sending results (in months)					2,9

Business type	Branch	Subsidiary	Head office	Grand Total
Corporate Banking	4	6	8	18
Depositary Bank	1	5	4	10
Private Bank	0	6	7	13
Retail Bank	0	1	7	8
Universal Bank	0	1	4	5
Grand Total	5	19	30	54

Source: CSSF

C. Interconnectedness with Foreign-Based Banking Parent Groups

46. The 2017 FSAP noted the extent of interconnectedness between Luxembourg-based subsidiaries and branches with their foreign-based banking parent groups and that intragroup transactions remained a significant feature of Luxembourg banking. Large intragroup exposures to foreign parent companies continue to represent a concentration risk due to the country's position as an international financial center comprising mainly subsidiaries and branches from internationally active banks. Total intragroup exposures stood at €225 billion at end-year 2017 and have increased steadily to €279 billion at end-March 2023. The share of total intragroup exposures relating to branches has steadily increased over that period, partly as a consequence of a number of banks converting from subsidiaries. At end-March 2023, around 70 percent of all

intragroup exposures were branch intragroup exposures. As a share of total assets of all Luxembourg banks, intragroup exposures have remained broadly stable since the last review at around 30 percent of total banking sector assets.

47. Luxembourg had opted for the Member State Discretion when exempting intragroup exposures from the large exposure limits available, in accordance with Article 493(3)(c) of the CRR and this Discretion is enshrined in Article 56-1 of the LFS. Article 56-1 allows banks to make use of the exemption if they meet all of the specified criteria listed in that Article, which state:

- the counterparty is a CRR institution, a third-country credit institution or a third-country investment firm.
- the financial situation in terms of risks and solvency and the liquidity situation of the counterparties concerned does not entail disproportionate credit risks for the CRR institution.
- the financing of the exposures concerned does not incur material liquidity risks for the CRR institution in respect of maturity mismatches and currencies.
- the exposures concerned would not trigger a disproportionate negative impact on the CRR institution where a resolution procedure had been applied to all or part of the group to which the CRR institution belongs. The CSSF has issued additional internal guidance that interprets the application of these criteria. This guidance goes further than ECB regulations by analyzing the home country's resolution regime to establish the treatment of intra-group liabilities in a bail-in situation.

48. The 2017 FSAP made a number of recommendations to improve the supervision of intra-group exposures, including formalizing the waiver approval process, introducing specific limits in respect of maturity and currency transformations, and requiring banks to submit specific details on their intragroup exposures. The CSSF has made significant progress in addressing these recommendations. The internal procedure for approving and monitoring intragroup waivers was most recently updated in 2023. All banks are now required to provide a detailed assessment of their compliance with the criteria in Article 56-1(1) when applying for a waiver. In addition to a detailed assessment against all of the criteria in Article 56-1(1), the CSSF considers the latest available data on the amount of deposits guaranteed by the Luxembourg Deposit Guarantee Fund (FGDL) to assess the risk that a default of intragroup claims could represent for the Luxembourg deposit guarantee scheme. Waivers granted undergo thorough periodic reviews by off-site supervision with a dedicated questionnaire submitted by LSIs and SIs to evaluate a bank's compliance with all the conditions listed in Article 56-1(1) of the LFS.

49. Specific limits in respect of currency and maturity transformations have not been introduced, but enhanced reporting of intragroup exposures commenced in 2018 to provide more granular data on intragroup maturity mismatches, including intragroup inflows and outflows per maturity bucket. Since 2017, the CSSF has been monitoring weekly, and more frequently in times of crisis, the CDS and ratings of parent entities and main counterparties, and the

sovereign debt ratings and bond yields of the country of origin of the parent entity and main counterparty. Waivers granted undergo thorough periodic reviews by off-site supervision, based on numerous information sources including a dedicated questionnaire submitted by LSIs and SIs to evaluate a bank's compliance with all the conditions listed in Article 56-1(1) of the LFS.

50. The CSSF has withdrawn six intragroup exemptions since 2017. The reasons for withdrawal include a parent company money laundering scandal, subordination of intragroup liabilities in the home country's insolvency law, significant deterioration in the credit quality of the group and a change in the legal status of the parent company which resulted in the type of counterparty no longer complying with the relevant criterion in Article 56 of the LFS.

51. In January 2021, the CSSF finished an extensive stocktake on the treatment of banks' intragroup exposures in case of a bail-in of the group. The Bank Recovery and Resolution Directive 2 (BRRD2) significantly reduces the bail-in risk for Luxembourg banks as Article 44(2)(h) of the directive excludes intragroup liabilities from bail-in subject to three conditions:

- The Luxembourg subsidiary is part of the same resolution group as the intragroup counterparty.
- The Luxembourg subsidiary is not designated as a resolution entity within the aforementioned resolution group.
- The liabilities in question do not rank below ordinary unsecured liabilities under the relevant national law governing normal insolvency proceedings.

52. In addition, article 46-6 of the BRRD law provides that where a subsidiary holds liabilities referred to in letter (h) of Article 44(2) of Directive 2014/59/EU that rank below ordinary unsecured liabilities under the law of the Member State governing normal insolvency proceedings applicable to the entity of the group that issued these liabilities, the Resolution Board shall assess whether the own funds and MREL instruments are sufficient to support the implementation of the preferred resolution strategy. Where the Resolution Board determines that the amount of such items issued by the subsidiary is not sufficient to support the implementation of the preferred resolution strategy, it shall adjust the MREL requirement in order to cover this insufficiency.

53. The CSSF has strengthened its monitoring and supervision of intragroup exposures, and specifically of the waiver process, since 2017. Although intragroup exposures continue to present a material feature of the Luxembourg banking sector, the CSSF has assessed the financial stability impact of such exposures in the event of failure and bail-in of the wider group. This risk is mitigated by the provisions of the BRRD2. The CSSF has effective ongoing supervisory procedures at both the bank and sector level to monitor intra group exposures to assess the risk to both individual LSIs and SIs and to the sector more generally.

D. Home-Host Relationships

54. The 2017 FSAP recommended that the CSSF ensure close interaction with the supervisors of the parents or groups of LSIs outside the Euro area. As of June 30, 2023, the CSSF was the competent authority for 62 LSIs and 13 branches of non-EU-credit institutions. Of these, the CSSF is host supervisor for 40 LSIs whose parent entity is located outside of Luxembourg and home supervisor for one banking group for which it exercises the ultimate consolidated supervision at European level. Ten LSIs are not part of any banking group. The CSSF either has Memoranda of Understanding with home authorities or participates in joint supervisory teams, supervisory colleges, coordinates in case of need at SSM level, or has annual meetings with home authorities.

55. Luxembourg exemplifies the challenges related to home-host relationships in small host jurisdictions where a significant portion of their banking sector comprises subsidiaries of large international banking groups. Small jurisdictions often host institutions that are systemically relevant at the domestic level but non-significant for the home supervisor and the international banking group. Lessons from past crises have shown that such subsidiaries can give rise to issues of under-capitalization and liquidity problems within the host country if the parent group encounters financial difficulties, with the associated fiscal costs. In times of crisis, experience demonstrates that all liquid and near-liquid assets within subsidiaries are transferred quickly to the ailing parent group. These challenges may have also broader implications for financial stability, market confidence, and the overall perception of the host jurisdiction's financial system.

56. Similar concerns arise in respect of TCBs where host countries have less legal certainty over the control of assets. The CSSF applies the same regulatory and supervisory framework for TCBs as for all other banks authorized in Luxembourg. TCBs are required to hold nominal capital upon authorization based on the minimum requirement under Luxembourg law (€8.7million) although most TCBs report much higher levels of capital than the minimum requirement. Most TCBs apply, upon authorization, for a waiver from the solvency requirements and no TCB has been refused a waiver to date. All TCBs are required to submit the normal suite of regulatory reports which are monitored in line with routine supervisory practice. Some reassurance is taken from the reported data on capital and liquidity within the branch, but it is untested in law whether the reported capital allocated to the TCB and placed locally would be available in the event of a failure at the parent bank.

57. At present, no TCB in Luxembourg currently holds a material amount of retail deposits. The business models of all TCBs in Luxembourg are predominantly trade-oriented and failure at parent bank level would have limited implications for the FGDL. Although not formally documented internally or publicly, the CSSF's current policy is not to allow a TCB to accept retail deposits on or after authorization. The EU is planning to harmonize the EU framework for TCBs and the CSSF is fully engaged in the ongoing policy development. The proposals aim to categorize TCBs into two classes (Class 1 and Class 2) based on specific criteria around size of assets and retail deposits. Class 1 TCBs will be required, inter alia, to hold a minimum 'capital endowment' based on a percentage of total liabilities with a minimum of €10million. Member States shall also provide authorities with the necessary powers to ensure that, among others, systemically important TCBs

defined as banks with aggregated assets in the EU above €40 billion assets may be required to subsidiarize. As it is possible that Luxembourg TCBs will look to accept retail deposits at some point in the future, the CSSF should consider whether the proposed thresholds set out in the EU set an acceptable risk appetite for the authority or whether additional, lower thresholds, would be more appropriate to future-proof its regulatory regime for such an eventuality.

58. Recommendation

- The CSSF should look to future-proof its third country branch regime in the event that TCBs seek to accept retail deposits.

E. Credit Risk

Sovereign Debt

59. The 2017 FSAP noted that Luxembourg banks had over €60 billion in sovereign debt at end-December 2015 and that the CSSF should monitor banks' holding of such debt closely. Sovereign bond holdings of all Luxembourg banks have fallen significantly since 2017, with total holdings standing at €37 billion at end-June 2023 (see Table 6). LSIs' sovereign bond exposures at €8 billion remain very low in terms of balance sheet size (5 percent) and their weighted average duration is circa one year.

60. Notwithstanding the fall in sovereign bond holdings since 2017, the CSSF's Macroprudential Division continues to monitor sovereign debt holdings by banks closely through its annual banking sector (solvency) stress test, analysis of weekly rating developments and semi-annual market risk monitoring. Furthermore, concentration risk analysis is also part of ongoing off-site supervision and SREP procedure by micro-prudential supervision.

Residential Real Estate Market

61. The 2017 FSAP recommended that the CSSF continue to monitor residential mortgage lending closely as real estate lending was concentrated in a small number of banks. The CSSF's Macroprudential Division and the BCL closely follow developments in the Residential Real Estate (RRE) market through various channels. Quarterly housing market variables are monitored such as housing supply, credit supply, house prices, housing demand, interest rates and other indicators such as price-to-income and debt-to-income data. Separately, they use their house price-at-risk model and a house price overvaluation model to stress future developments in the RRE market. Further consideration of the work conducted in this area by the BCL and CSSF has been considered in the second part of the FSAP mission in January 2024.

Credit Register

62. The 2017 FSAP noted that there was no credit bureau in Luxembourg but that the BCL was party to an ECB initiative to introduce a harmonized credit database across the euro area. The review recommended that the BCL and CSSF should continue to work closely with the ECB to

expand the scope of the initiative to include household exposures. The ECB (Anacredit) initiative has progressed and is currently scheduled to go live in 2027. However, the database being drawn up by the ECB will be limited to corporate exposures, not households and not made publicly available to banks.

63. Separately in 2019, Luxembourg's macroprudential authority, the Systemic Risk Committee (CdRS), set up a working group tasked with analyzing the setting up of a credit registry in Luxembourg. The working group, chaired by the BCL, brings together the ABBL, the Insurance Companies Association (ACA), the National Commission for Data Protection (CNPD), the MoF, the CSSF and the CAA. The establishment of a credit register could have two objectives from a public policy perspective: (i) to contribute to financial stability by preventing over-indebtedness and (ii) to allow authorities and lenders to have a complete and central overview of a borrower's debt. Progress was delayed by Covid, but the working group has produced a first draft report which covers, inter alia, the information to be included in the registry (e.g., nominative information on natural persons, loan materiality thresholds, entities covered by the scope (e.g., non-bank entities), as well as the considerations to be given as regards the future legal setup (private law, professional secrecy constraints, other legislative issues). The Working Group should expedite its work on this project and set clear deadlines for its completion.

64. Recommendation:

- The developmental work on setting up a credit register should be actively pursued by all parties on the Working Group with clear deadlines set.

F. Regulation of Nonbank Holding Companies

65. The 2017 FSAP recommended that, in line with the recommendations of the 2016 Article IV Staff Report, the authorities should advocate for stronger oversight at the European level of nonbank holding companies that include banks. This was established on June 7, 2019 with the publication of Directive (EU) 2019/878 amending Directive 2013/36/EU (CRD). Inter alia, this introduced new approval and oversight powers relating to financial holding companies and mixed financial holding companies (CRDV). The transposition of the CRD V was carried out through the law of May 20, 2021 (the Law), which amends the LFS. The Law implements new requirements of the CRD V applicable to financial holding companies and mixed financial holding companies (MFHCs). In this respect Articles 34-1 to 34-3 of the LFS (transposing Art. 21a of the CRD V) introduce a new approval process for and direct supervisory powers over certain MFHCs. The aim of this procedure is to ensure that such holding companies can be held directly responsible for ensuring compliance with consolidated prudential requirements stemming from CRD V and Regulation (EU) No 575/2013 (CRR).