Circular CSSF 12/552 "Central administration, internal governance and risk management"

Salient elements

December 2012
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Why a new circular?

1. Consolidation of the various circulars which refer to Articles 5 (1a) and 17 (1a) of the LFS (law of 5 April 1993 on the financial sector).
   - IMF recommendation (2010 FSAP mission)
   - Desire expressed by the industry

2. Incorporation into the Luxembourg regulations of common sense rules regarding risk management in the fields of
   - credit and in particular residential mortgages to individuals
   - private banking
Why a new circular?

3. Transposition of the following international guidelines into Luxembourg regulations:
   - EBA guidelines on internal governance of 27 September 2011
   - BCBS guidelines on the internal audit function in banks of 28 June 2012
   - EBA guidelines on the management of concentration risk of 2 September 2010
   - EBA guidelines on liquidity cost benefit allocation of 27 October 2010
Consolidation of the regulatory framework

- In view of the aforementioned 1st reason, the following circulars relating to banks and investment firms are repealed \(^1\):
  - IML 93/94
  - IML 95/120*
  - IML 96/126*
  - IML 98/143*
  - CSSF 04/155*
  - CSSF 05/178*
  - CSSF 10/466

- The existing circulars relating to the risks and their management will supplement Part III of the circular at a later date

\(^1\) The circulars marked with an asterisk remain in force for payment institutions, electronic money institutions and PFS other than investment firms
Structure of Circular CSSF 12/552

- Part I: Definitions and scope
- Part II: Central administration and internal governance arrangements
- Part III: Risk management
- Part IV: Entry into force, transitional measures and repealing provisions

Observation: References to the circular are presented as follows:
- [v.w.x.y.z] refers to sub-section z of section y of sub-chapter x of chapter w of part v
- [§a] refers to item a (continuous numbering)
Part II of Circular CSSF 12/552

- Part II: Key provisions as regards administration and internal governance
  - Chapter 1-3: Central administration and internal governance
  - Chapter 4: Board of directors and authorised management
  - Chapter 5: Administrative, accounting and IT organisation
  - Chapter 6: Internal control
  - Chapter 7: Specific requirements
Key provisions as regards administration and internal governance (1/2)

- Reassertion of the principle of central administration (IML 95/120) [II.1] and the principles governing the sound administrative accounting and IT organisation (IML 96/126) [II.5]

- (Minimum) requirements regarding the "internal governance arrangements" (IG) in terms of
  - components: organisation chart, internal control mechanisms, risk management process [II.2; §10];
  - properties: effectiveness, comprehensiveness, integrity, robustness [II.3].

- Prudential framing and clarification of the roles and responsibilities of the institution's bodies - authorised management (AM) and board of directors (BD) [II.4]
Roles and responsibilities BD and AM

- **BD**: "to ensure the execution of activities and preserve business continuity" [§17]
- **AM**: "effective, sound and prudent day-to-day management [...] safeguarding the institution’s long-term financial interests [§52]"

**BD**
- **strategies:**
  - business model
  - risks
  - capital and liquidities

- **guiding principles:**
  - internal governance

**recipes**
- own funds/liquidity
- strategies/guiding principles
- organisation
- internal control
- management (AM)

**AM**
- **policies**
- **procedures**

Key provisions
Key provisions as regards central administration and internal governance (2/2)

- Internal control mechanisms [II.6]
  - include four levels of control (IML 98/143) [%100] and comply with the three lines of defence model [%9]
  - include three internal control functions (ICFs) in the fields of internal audit, compliance and risks [II.6.2]

- Confirmation of the regulatory requirements regarding internal audit (IML 98/143) [II.6.2.7] and compliance (CSSF 04/155) [II.6.2.6]

- New requirements as regards risk control: obligation to have now a Chief Risk Officer (without prejudice to the principle of proportionality) [%105]
Part II.6 of Circular CSSF 12/552

- Part II: Central administration and internal governance arrangements
  - Chapter 6: Internal control
    - Operational controls [II.6.1]
    - ICFs [II.6.2]
    - 4 "levels" of control [§100]

- Sub-chapter 6.2: ICFs
  - Common part [II.6.2.1-II.6.2.4]
  - Risk control function [II.6.2.5.]
  - Compliance function [II.6.2.6.]
  - Internal audit function [II.6.2.7.]
Interactions between BD, AM and ICF
(in normal circumstances “→→”)
Interactions between BD, AM and ICFs
(in times of stress “→”) [§22, 62 et 116]
Main changes in the internal governance regulations (1/4)

**Strengthening of the BD's capacity of control:**

- "Collective fitness" of the BD in terms of professional competences [§23, 24] and ongoing training [§27]; personal qualities of its members [§23, 25].
- Specialised committees (audit and compliance, risks) [II.4.1.4]. The CSSF recommends the creation of audit/risk committees for important/risky institutions [§39, 46].
- Specific points:
  - The authorised director cannot chair the BD [§32].
  - The CSSF recommends larger institutions to have one or several independent directors [§31].
Main changes in the internal governance regulations (2/4)

**Enhanced ICF arrangements:**

- Reporting lines and access of ICFs to AM and BD [§105, 116]
- Nomination and revocation of the persons in charge of the ICFs are approved by the BD and justified in writing to the CSSF [§105]
- Characteristics: permanence, independence, authority, objectivity, competences and own resources [II.6.2.2]
- Group head function [§119-121, 108]
- Risk control function with its own resources [§112] and led by the Chief Risk Officer [§105].
Risk control function [II.6.2]

- "in charge of the anticipation, identification, measurement, monitoring, control and reporting of all risks" [§123] including in particular:
  - adequacy and follow-up of limits [§124]
  - adequacy between the risks and ability to assume these risks [§125]
  - adequacy of the risk management/control [§126,127] and [III.1]
  - emerging risks [§128] and [II.7.3]
- A charter is not required for the risk control function.
Main changes in the internal governance regulations (3/4)

New "components" of the "IG" arrangements:

- Internal code of conduct [§55]
- Internal whistleblower procedure [§90]
- Positions as IT Officer and Information Security Officer (ISO) (in French "Responsable de la Sécurité des Systèmes d’Informations (RSSI)") [§86]
Main changes in the internal governance regulations (4/4)

**Specific requirements [II.7]:**
- "Know-your-structure", including vehicles created on behalf of clients [II.7.1]
- Conflicts of interest, including in relation to the related parties [II.7.2]
- "10 consecutive days off" rule [§74]

- New product approval process (and new activities) [II.7.3]
- Recast and update of the prudential rules as regards outsourcing (CSSF 05/178) [II.7.4]
Proportional implementation in "small" institutions

- Specialised committees as an option [§33, 39 and 46]
- Independent directors as an option [§31]
- Compliance and risk control functions on a part-time basis or assumed by an authorised manager [§129, 141]
- Outsourced internal audit [§157]
- Functions of IT Officer and Information Security Officer (ISO) [§86]
- Use of external experts for ICFs, IT Officer and ISO [§86, 118]
- But: Avoidance system/management of conflicts of interest [§4, 72]

- Observation: Proportionality [§4] is a symmetrical principle based on up and down movements
Part III of Circular CSSF 12/552

- Part III: Risk management
  - Chapter 1: General principles as regards risk measurement and risk management
  - Chapter 2: Concentration risk
  - Chapter 3: Credit risk
  - Chapter 4: Risk transfer pricing
  - Chapter 5: Private wealth management ("private banking")
Key provisions regarding risk management

- The circular currently contains only an embryonic part dedicated to the "risk" component (cf. 2nd indent of slide n°5)

- This part includes:
  - the requirements of EBA relating to governance and risk measurement included in the EBA guidelines on internal governance (27.9.2011) [III.1]
  - EBA guidelines on risk concentration (2.9.2010) [III.2] and liquidity cost benefit allocation (27.10.2010) [III.4]
  - common sense principles of a sound and prudent management in the fields of credit [III.3] and private banking [III.5]
  - (additional) capital requirements due for residential mortgage risks
Key provisions as regards credit risk (1/3)

- Prior written analysis on the debtor's creditworthiness [§221]. Only the business function can grant credit [§222, 223].

- Any credit restructuring is subject to the aforementioned decision-making process [§225].
  - List of restructured credits
    - Objective: to monitor forbearance

- Identification and management of past due commitments [§226] and doubtful commitments [§226].
  - List of doubtful commitments:
    - Objective: strict framework for determining the provisions et impairment
Prudential rules applying to residential mortgages to individuals:

- "Prudent" policy in terms of LTV [§228];
- (additional) capital requirements [§229]:
  - Standard approach: the 35% preferential rate is not applicable to mortgages whose LTV exceeds 80%;
  - Internal ratings-based approach: LGD floor maintained at 10% after 31.12.2012 and minimum calibration of the regulatory stress tests. PD*1.5 et LGD = 20%;
- CRD IV-based regime
Key provisions as regards credit risk (3/3)

- Prudential rules applying to credits granted to real estate developers: [§230]
  - At first, setting of the start date of the principal repayment. After this deadline, the unpaid interests shall be fully paid.
  - In principle, personal guarantee of the developer.
  - Internal limit for the aggregate exposure on the real estate development, in healthy proportion of their capital.
Implementation and future developments

- Entry into force on 1 July 2013
- Transitional period (up to 1.1.2014) for the new requirements imposed on the BD [§241]

- Future developments:
  - Practical implementation
  - Transposition of the EBA Guidelines on the assessment of the suitability of members of the management body and key function holders (22.11.2012)
  - Transposition of the rules as regards internal governance laid down in the future European CRD IV/MiFID II
  - Consolidation of the circulars existing in respect of the management