

Circular CSSF 21/773 on climate-related and environmental risks

Outcomes of the self-assessment exercise 2022

Closing webinar

20 June 2023



Commission de Surveillance
du Secteur Financier

Agenda

1. Regulatory background
2. Outcomes of the self-assessment exercise 2022
 - A. Reminder: design and purpose of the exercise
 - B. Overview of results
 - C. Good practices identified
3. CSSF supervisory approach 2023-2024

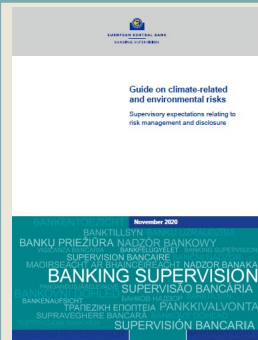
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Regulatory background

Scope – LU credit institutions

Current regulation

Significant Institutions (including their subsidiaries & branches)



ECB Guide on climate-related
and environmental risks
(November 2020)

Less Significant Institutions & Third country branches



Circular CSSF 21/773 (June 2021)



BIS

BCBS Principles for the effective management and supervision of climate-related financial risks
(June 2022)

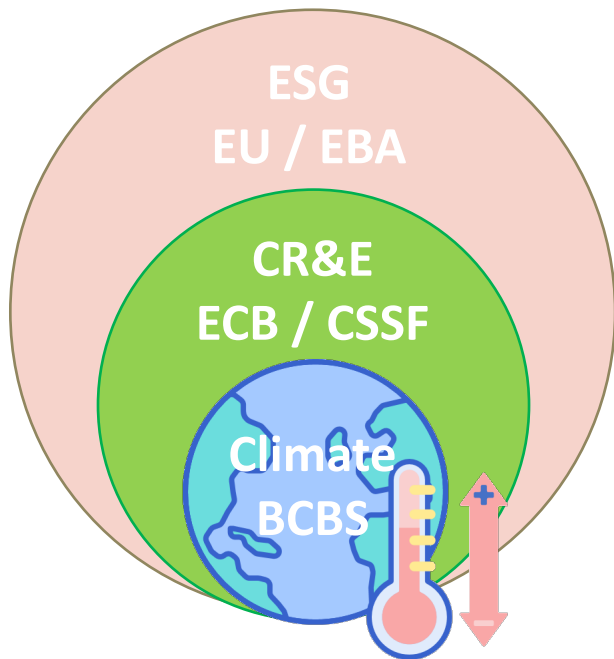
Upcoming



CRD VI (2023? 2024?)

EBA Guidelines on ESG risks management (2025? 2026?)

Scope - Thematic



■ EU/EBA scope → CRD VI

- ESG = Environmental, Social and Governance risks

■ ECB & CSSF scope

- CR&E risks = Climate-related and Environmental risks
 - Physical risks
 - Transition risks

■ BCBS scope

- Climate-related Financial Risks
 - Physical risks
 - Transition risks

Outcomes of the self-assessment exercise 2022

Reminder: design and purpose of the exercise

Reminder: Motivation for the self-assessment exercise

- The Circular CSSF 21/773 describes how the CSSF expects credit institutions to consider and integrate into their operations climate-related and environmental risks ("CR&E risks")
- Scope of Circular CSSF 21/773: LSIs and third country branches (63 institutions at YE 2022)
- Objectives of the self-assessment exercise
 - Assess banks' compliance with the provisions of the Circular
 - Improve banks and supervisors' knowledge of CR&E risks assessment
 - Being prepared for the introduction of CR&E risks assessment in the SREP
- Qualitative measures (recommendations) may be issued on a case-by-case basis
- A similar exercise had been carried out in 2021 by the ECB for Significant Institutions
- We selected a sample of 12 Less Significant Institutions and 3 branches of non-EU credit institutions, representing different business models in Luxembourg, based on the following principles:
 - Target the most important LSIs (in term of size)
 - Cover all the relevant business models

Reminder: Timeline



Outcomes of the self-assessment exercise 2022

Overview of results

Outcomes of self-assessment exercise 2022-2023

How institutions' practices align with CSSF expectations, mapped against the adequacy of their plans to advance those practices – following CSSF review

Y-axis

Supervisory assessment of alignment of institution's practices to expectations

Fully aligned

Mostly aligned

Partially aligned

Not aligned

Inadequate

Somewhat inadequate

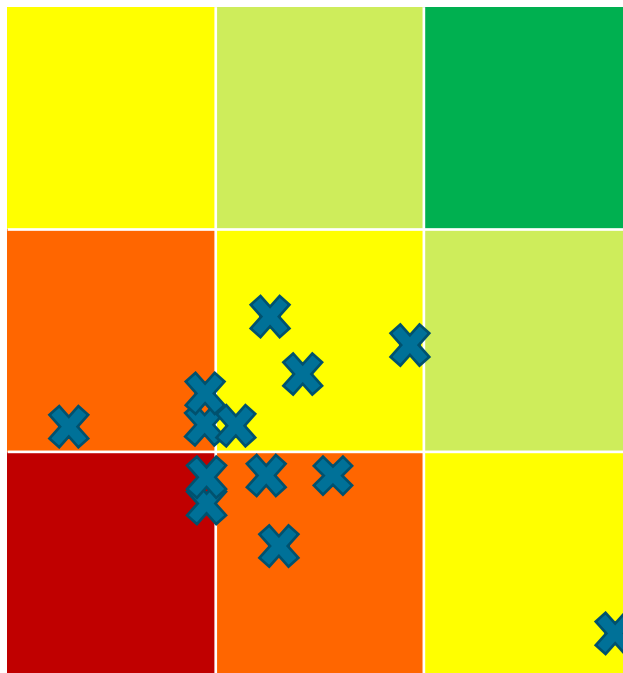
Somewhat adequate

Adequate

X-axis

Supervisory assessment of adequacy of institution's plans

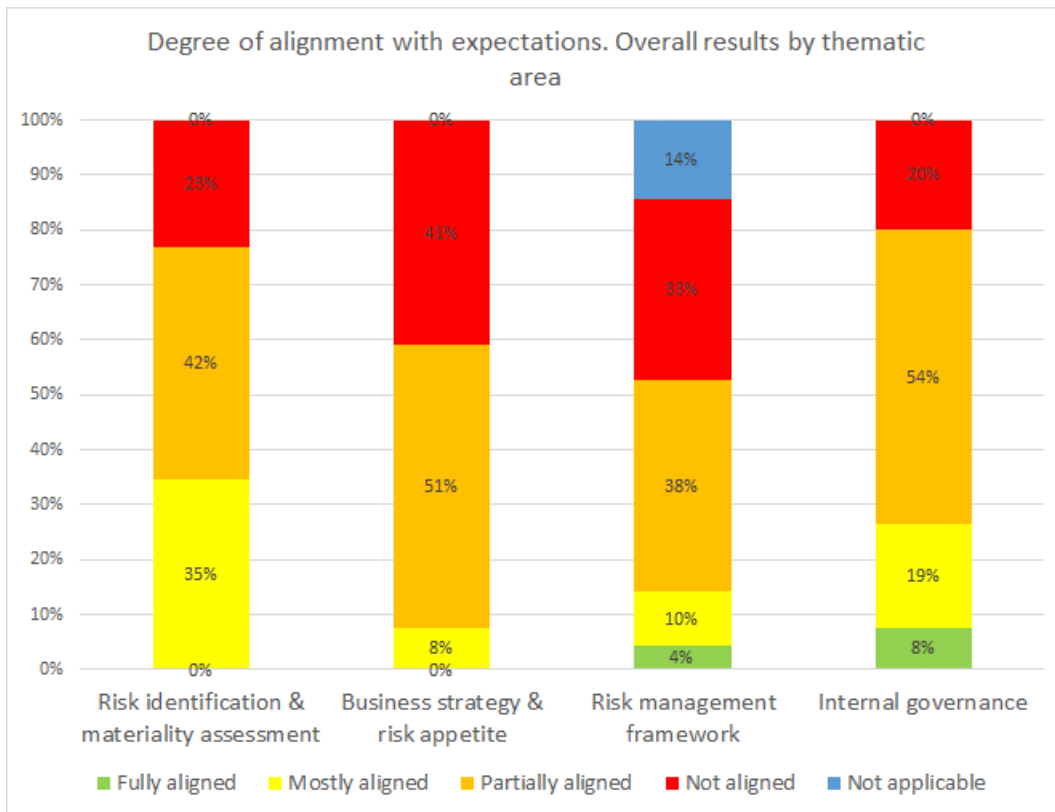
✕ LSI or third country branch



Outcomes of self-assessment exercise 2022-2023

Degree of alignment with expectations, by thematic area

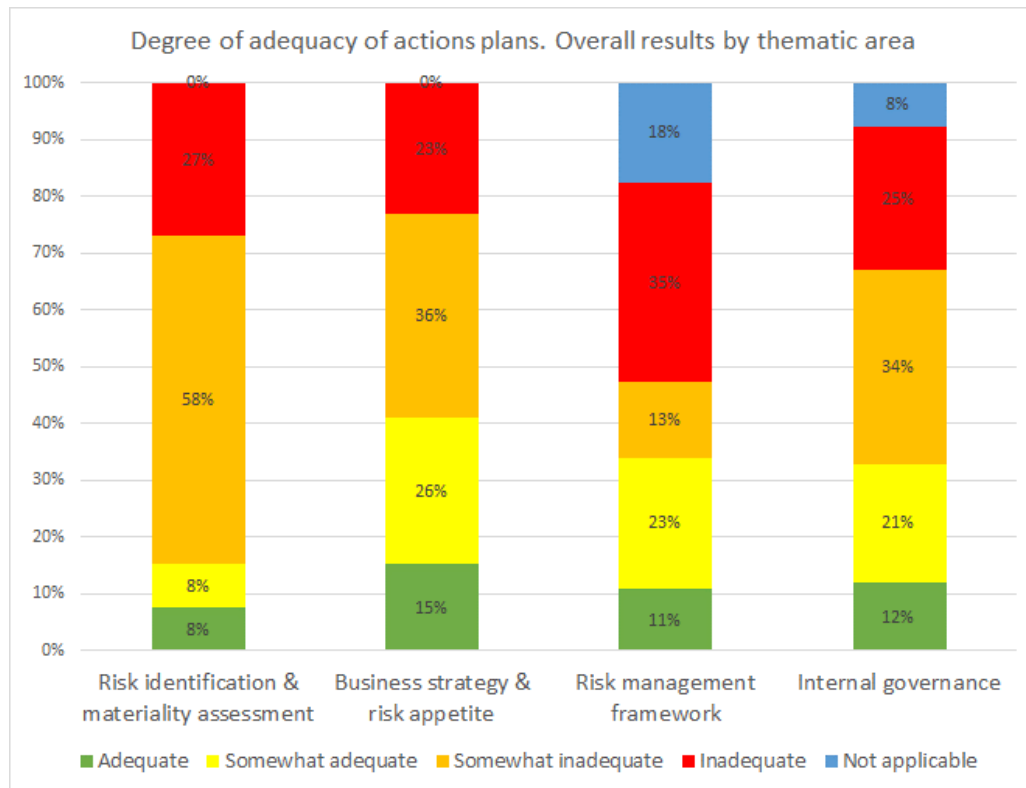
- Only 35% of the banks have achieved concrete progress regarding CR&E risks identification and materiality assessment.
- CR&E risks drivers are rarely considered in banks' business strategy and risk appetite. It appears very challenging for banks to determine and compute meaningful KRIs due to lack of reliable (internal or external) data.
- Risk management framework needs to be improved to take into account CR&E risk drivers. In particular, stress testing practices hardly include CR&E risk drivers.
- Some progress is observed in internal governance. Institutions started to update their policies, assigned responsibilities for managing C&E risks and deployed dedicated trainings.



Outcomes of self-assessment exercise 2022-2023

Adequacy of actions plans, by thematic area

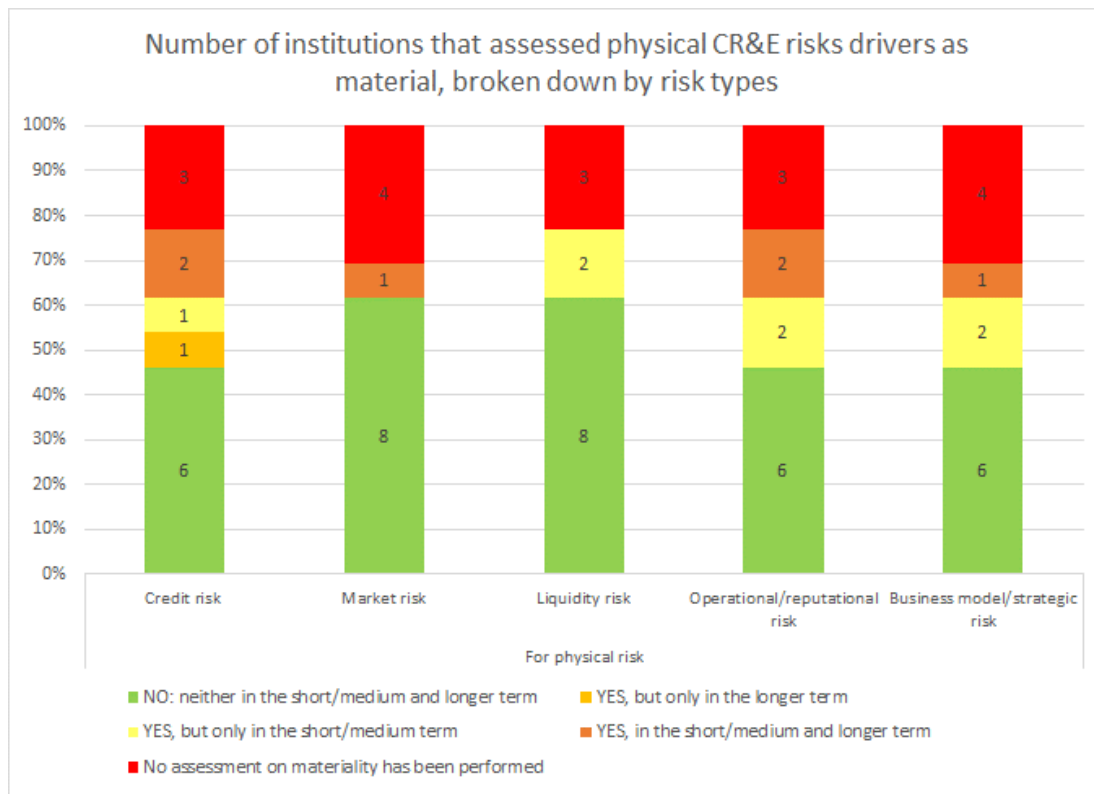
- As of 30 September 2022, most banks did not have a formal action plan in place with monitoring of deadlines, clear responsibilities and resources implications.
- All banks (except two) shall implement a comprehensive action plan to ensure full compliance with expectations set in CSSF Circular 21/773, with deadlines for end 2024.



Outcomes of self-assessment exercise 2022-2023

Assessment of physical risk drivers by banks

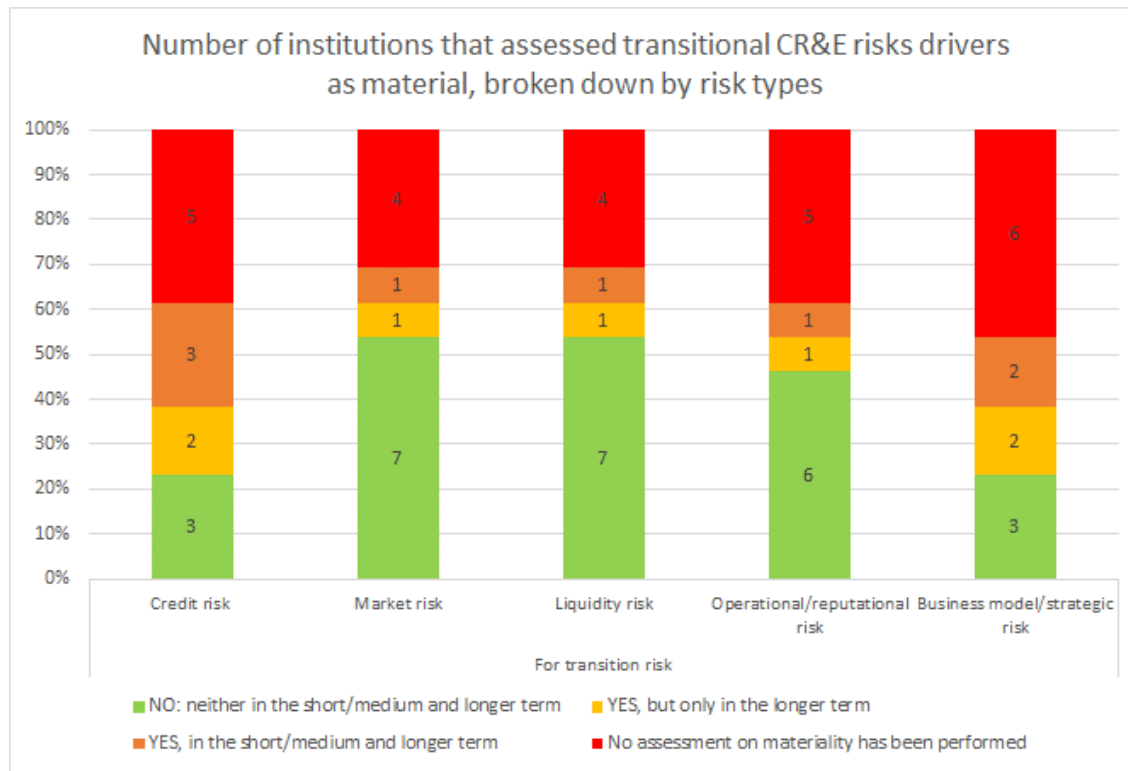
- Most of the institutions report that physical risk drivers are not material. However the materiality assessment needs significant enhancements for 65% of the banks, hence assessment is often not robust enough.
- Institutions view credit risk and operational risk to be most often materially impacted by physical risks drivers.



Outcomes of self-assessment exercise 2022-2023

Assessment of transitional risk drivers by banks

- Transitional risk drivers seems more difficult to assess, as almost 40% of the institutions did not assess those risk drivers.
- Market risk and liquidity risk are assessed less impacted by CR&E risk drivers. This is often explained by the business model of the sampled LSIs which entails limited market and liquidity risks.
- Transitional risk drivers are assessed as having a material impact especially in the longer term.



Outcomes of the self-assessment exercise 2022

Good practices identified

Good practices identified

Risk identification and materiality assessment (1/2)

■ Matrix:

- comprehensive list of relevant CR&E risk drivers
- mapping against the traditional risk categories
- bank's risk taxonomy

■ Qualitative assessment of materiality through a risk differentiation scale

- "Low-medium-high" or "green-amber-red"
- Severity of each CR&E risk driver assessed and thresholds are used
- Basis of thresholds:
 - potential capital impact or potential loss
 - likelihood
 - qualitative judgment
- Quantitative dimension
 - Example: volume of exposures and/or collateral by vulnerable sector / geographical area => concentrations?

■ Initial assessment complemented by a sensitivity analysis or a scenario analysis

- Example: operational risk => "natural disaster event" scenario analysis

Good practices identified

Risk identification and materiality assessment (2/2)

- Stylized outcome of a materiality assessment matrix:

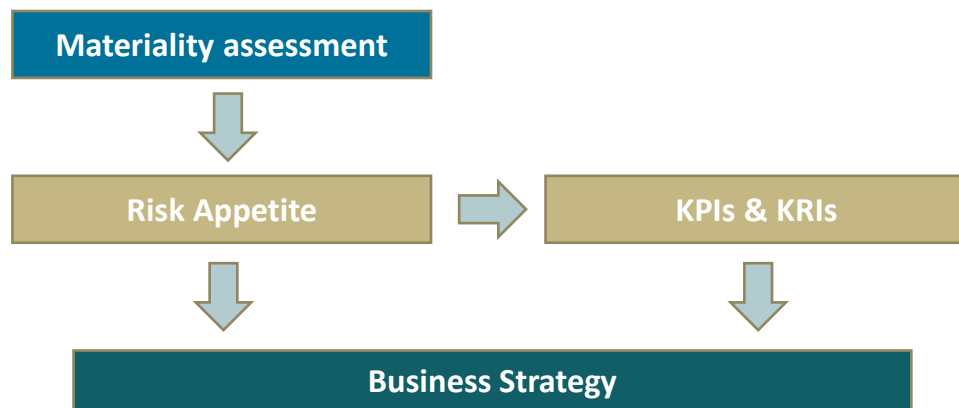
	Transition risk		Physical risk	
	Short term	Longer term	Short term	Longer term
Credit risk	Medium	Very high	Low	Medium
Market risk	Low	Medium	Low	Low
Liquidity risk	Low	Low	Low	Medium
Operational / reputational risk	Medium	High	Medium	High
Business model / strategic risk	Medium	Very high	Low	Low

- Reputational risk was often a blind spot: few banks used a scenario analysis.

Good practices identified

Business strategy and risk appetite

- A comprehensive risk identification and materiality assessment allows the bank to identify material CR&E risk drivers
- Those material CR&E risk drivers are integrated in the bank's business strategy and risk appetite
- The bank sets targets (KPIs) and limits (KRIs) for those areas of material risk exposure



Good practices identified

Business strategy and risk appetite – KPIs & KRIs

Indicator	Activity	Indicator implemented
KPI	Wealth management	Percentage of AuM considered sustainable (internal definition) should reach at least 30% by 2025.
	Depository	Percentage of funds/AuC invested in high risk sectors/countries. Percentage of sub-custodians/third party vendors operating in high risk countries.
KRI	Own portfolio	Investments in bank's securities portfolio at FVOCI should reach a minimum ESG score (based on external rating and internal scoring scale). Percentage of own portfolio exposure to climate risk sensitive assets should remain below 20%.
	Lombard loans	Collateral from vulnerable countries or sectors (internal definition) should remain below 30% for each client.
	Corporate loans	Progressive phase out of certain sectors that do not match the institution's CR&E risks related objectives : exposure limit by sector reviewed on a yearly basis.

Good practices identified

Risk management framework – Credit risk

Portfolio	Level	Practices implemented
Lombard loans	Borrower	Systematic negative news search of the borrower to cover sustainability and reputational risk. Outcome of these checks are integrated within the credit assessment file.
	Borrower	Use of loan proceeds is considered to check whether the bank could indirectly finance controversial activities.
	Collateral	Internal list of “ESG-at-risk issuers” is defined. Collateral value of securities from those issuers may receive additional haircut, based on quantitative and qualitative criteria as well as expert judgment. Controls are implemented at loan origination and monthly monitoring is in place.
Corporate loans	Borrower	Collection of a set of CR&E information on the borrower at the time of due diligence (sourced from a data vendor or directly from the borrower through a dedicated questionnaire). Those data are integrated in the credit assessment file.
		<div> <p>Thresholds are defined and could trigger escalation to CR&E specialists for expert judgment, potentially impacting the final credit decision.</p> </div> <div> <p>Questionnaires allow to determine a CR&E score for each counterparty. This score is integrated in the internal credit rating, potentially impacting interest rates, terms, and collateral requirements.</p> </div>

Good practices identified

Risk management framework – Operational risk

Operations	Practices implemented
Bank's premises in LU	Business continuity plan considers physical risk drivers (flood risk).
Outsourcing	<p><u>To entities of the same Group:</u> Systematic review of the respective Business Continuity Plan for each material outsourcing => consideration of physical risk drivers (including indirect impact: e.g. power outage).</p>
	<p><u>To suppliers:</u> Physical risk drivers considered in the Know Your Supplier process for any material outsourcing.</p>
	<p><u>To service providers:</u> Development of stress test scenarios to assess impact of CR&E risk drivers on service providers</p>
Sub-custodian network	Dedicated questionnaire to sub-custodians and third party vendors

Good practices identified

Internal governance – Action Plan

■ Example of an action plan developed by a bank

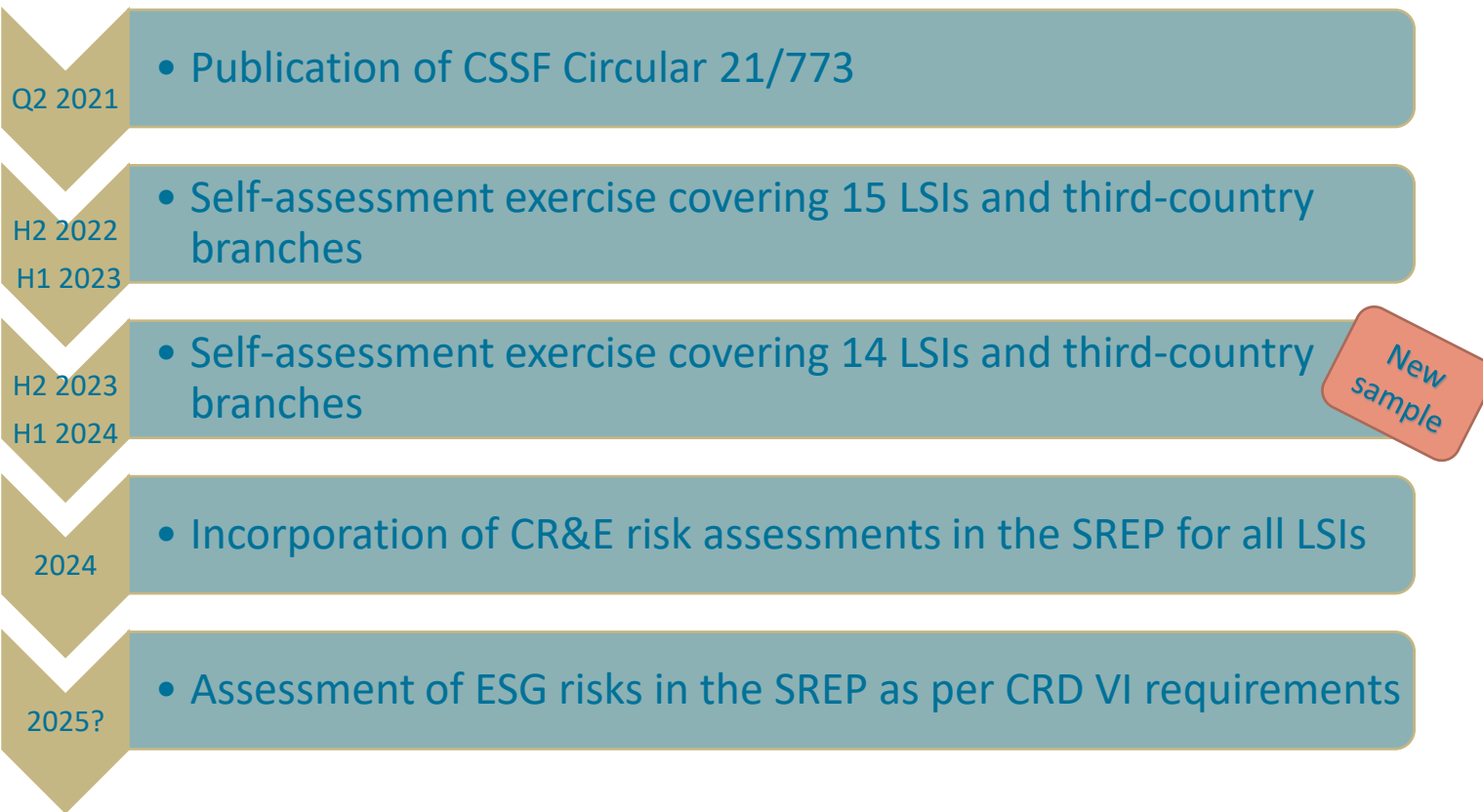
Area	Expectations	Action Plan	Owner	Effort	Status	Due Date
Risk Identification	Expectation 1	Perform a materiality assessment	Risk Management ESG Leader	Medium	Complete	Q4 2022
	Expectation 2	Identify CR&E risks	Risk Management ESG Leader	Medium	Almost complete	Q2 2023
Business Strategy & Risk Appetite	Expectation 3	Integrate CR&E risks into the bank's business strategy	Strategy Team	Low	Half complete	Q4 2023
	Expectation 4	Include CR&E risk indicators and limits into the RAF	Risk Management	Medium	Not started	Q1 2024
	Expectation 5	Develop KPIs & KRIs relevant to the bank's business	Risk Management	Medium	Not started	Q1 2024
...

Effort: Low (<x person days), Medium (x to y person days), High (>x person days).

Status: Not started, Initially started (25% complete), Half complete (50% complete), Almost complete (75% complete), Complete.

CSSF supervisory approach 2023-2024

Next steps: 2023 and beyond

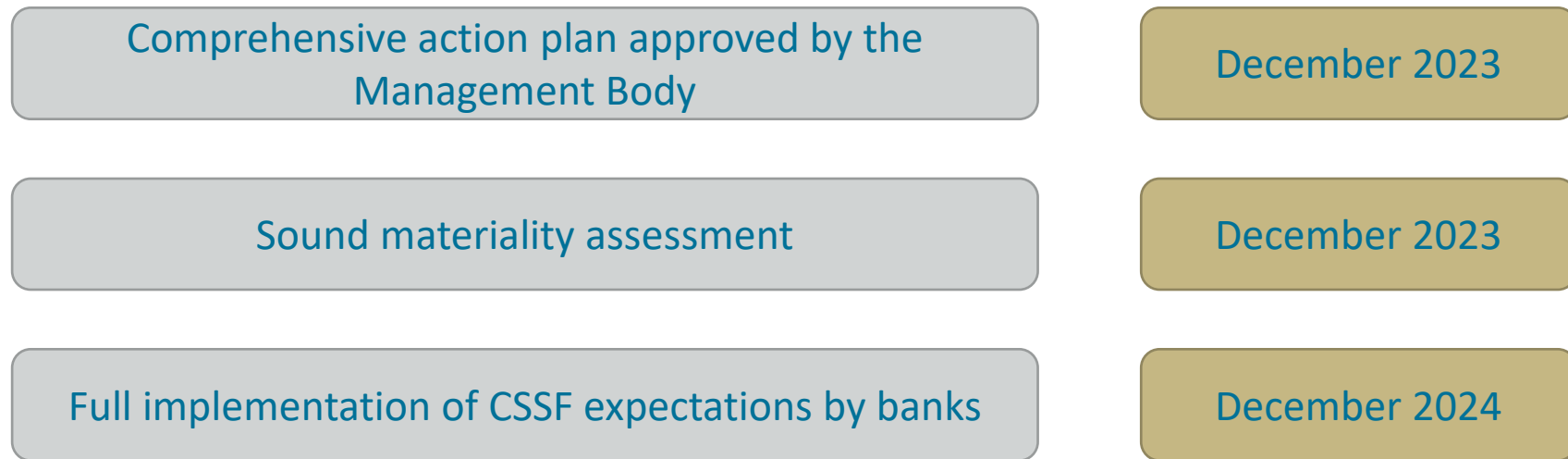


CR&E risks
dimension
integrated in
**on-site
inspections
plan**

Timeline of self-assessment exercise 2023-2024



Implementation timeline expected by CSSF



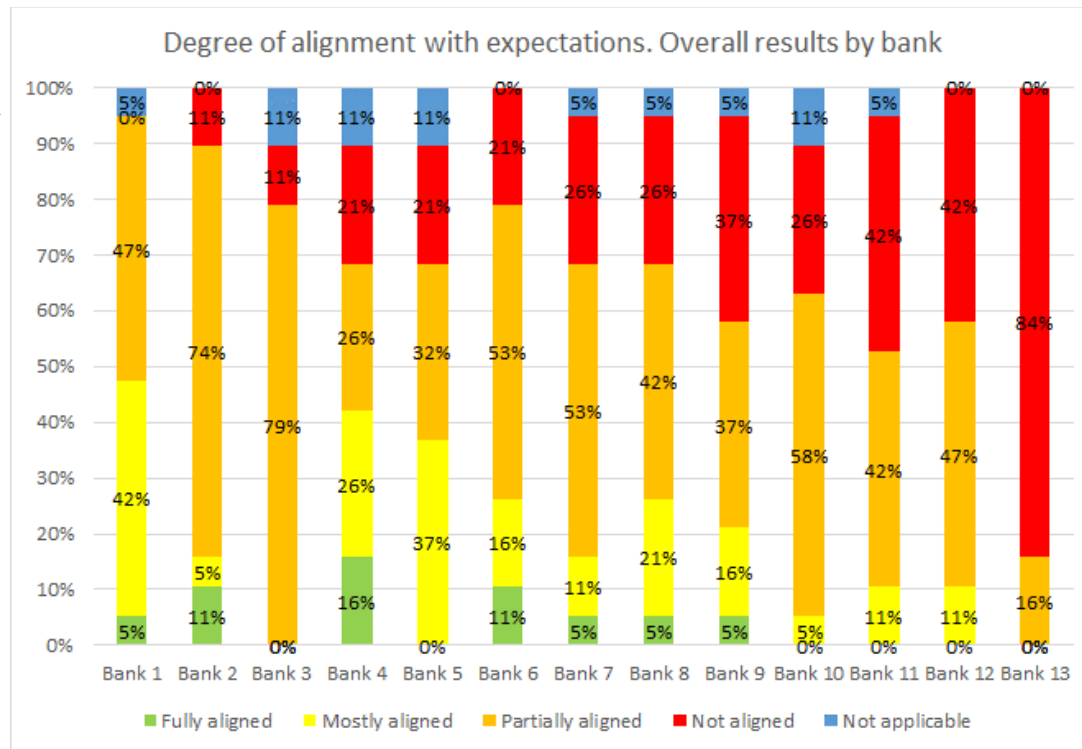
Appendix 1

Overview of results

Outcomes of self-assessment exercise 2022-2023

Degree of alignment with expectations, by bank

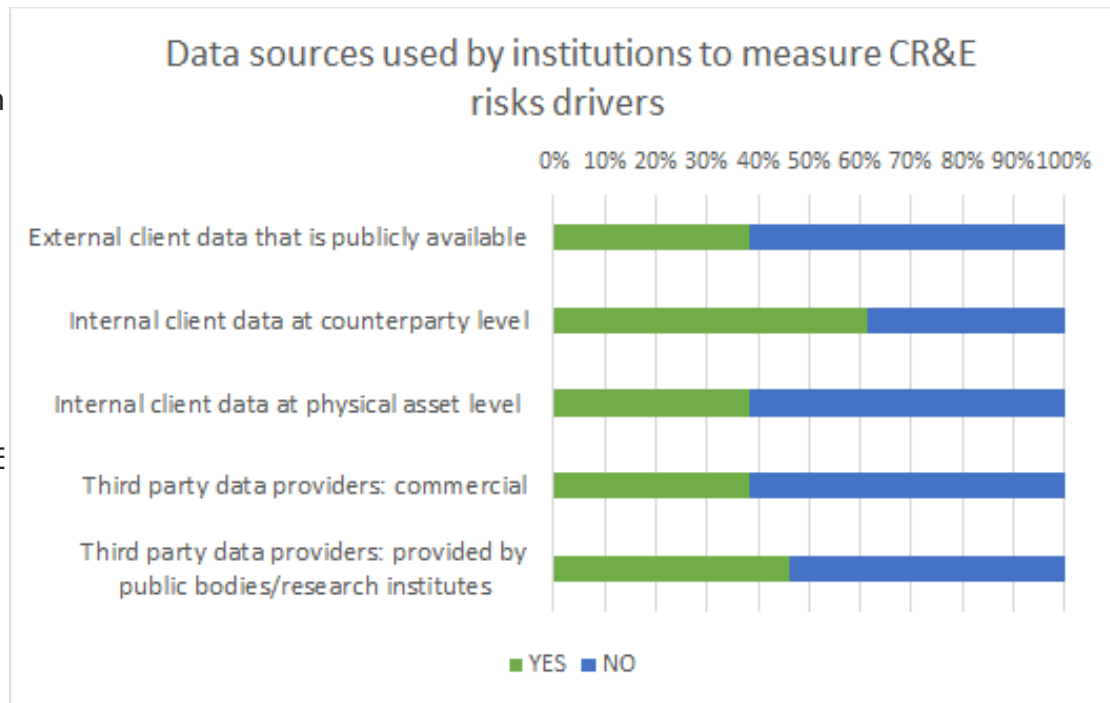
- All banks have started to adapt their practices, demonstrating a widespread awareness of CR&E risk drivers.
- However, for all banks, significant progress is still necessary to comply with CSSF expectations.
- It seems that several banks started to adapt their practices only when they received the CSSF self-assessment questionnaire.
- For subsidiaries of non-EU banking groups, the outcome is influenced by the degree of preparedness at Head Office level.



Outcomes of self-assessment exercise 2022-2023

Data sources used by institutions

- Institutions mainly use internal client data already available, in order to assess impact of CR&E risk drivers on credit risk.
- Internal client data at physical asset level are also used to assess physical risk for real estate collateral.
- Third party data providers are less used for the time being. We understand that several banks are conducting due diligences to select a data provider in order to collect CR&E risk rating for their counterparties.



Appendix 2

Good practices

Good practices identified

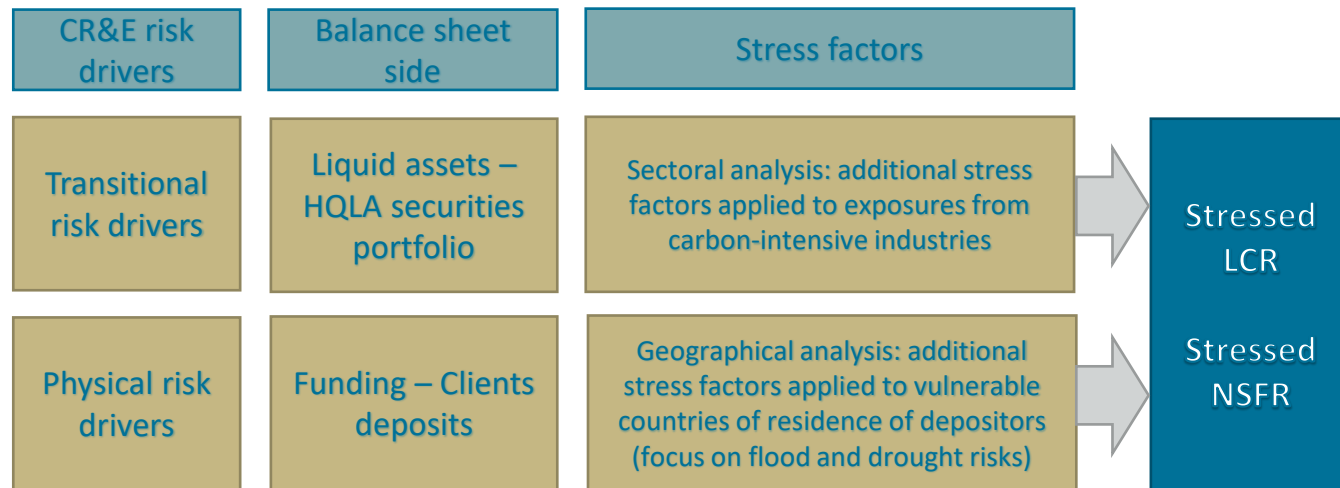
Risk management framework – Reputational risk

CR&E risk drivers	Activity	Process	Practice implemented
Transitional risk drivers	Corporate banking	Due diligence - Corporates	Use of a qualitative and quantitative questionnaire to collect CR&E data at the client level, and to evaluate the client's approach with respect to climate & environmental topics. Questionnaires allow to determine a CR&E risk score.
	Wealth management	Know Your Customer	Analyze source of wealth coming from controversial sectors. If percentage is above a certain threshold, further analysis is performed for KYC Committee decision.
	Depository	Due diligence - Funds	Questionnaire on new clients collecting information on the investment fund features: type of assets, sector of investment, geographical area and disclosure of information according to SFDR.

Good practices identified

Risk management – Liquidity risk stress test

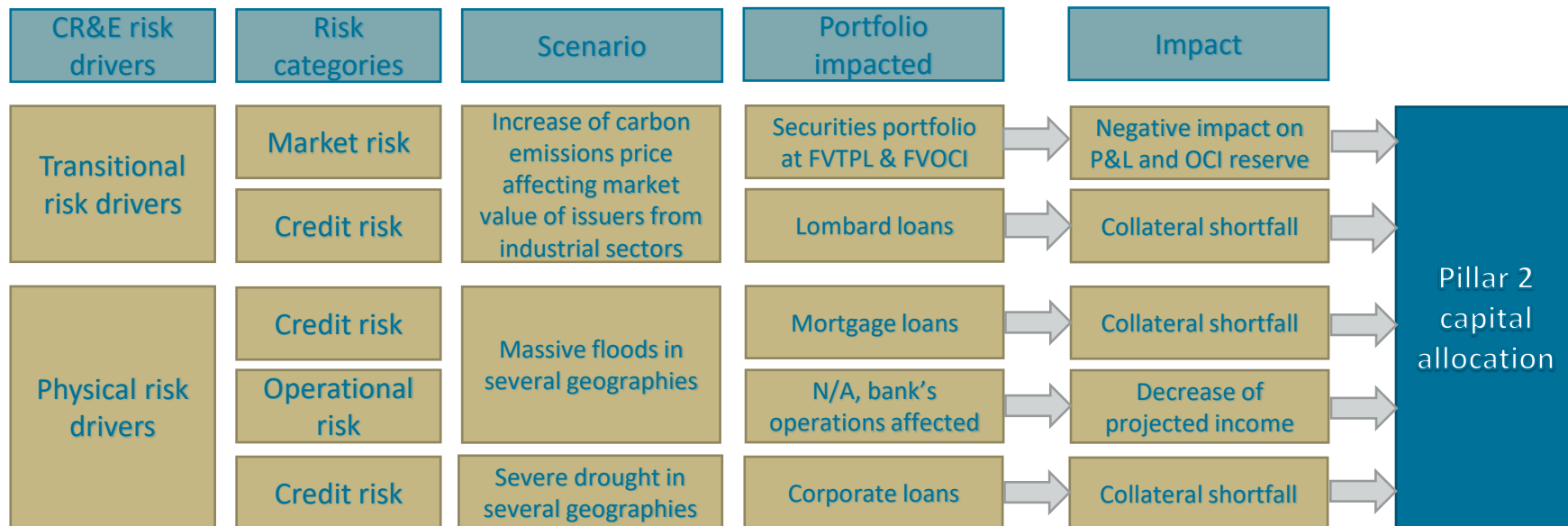
- Example of a dedicated liquidity stress test developed by a bank



Good practices identified

Risk management – Solvency stress test & capital adequacy

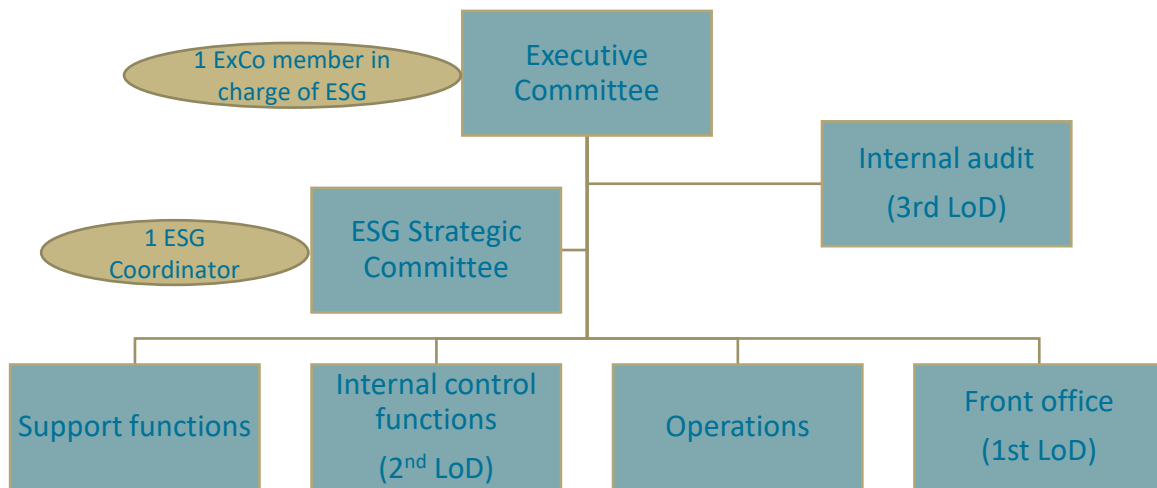
■ Example of a solvency stress test developed by a bank



Good practices identified

Internal governance - Responsibilities (ExCo level)

- Example of a bank having assigned responsibility for the management of CR&E / ESG risks within the organizational structure in accordance with the three lines of defense model



Good practices identified

Internal governance - Trainings

■ Example of a comprehensive CR&E training plan

General ESG training provided to all staff (typically e-learning)
Adapted to the business model
Developed in house or by an external provider

Dedicated training for Front
office (1st LoD)

Typically developed in house

Dedicated training for Risk control
(2nd LoD)

Developed in house or by an
external provider

Dedicated training for Compliance
(2nd LoD)

Developed in house or by an
external provider

Workshop for Executive Committee and Board members
Developed in house or by an external provider

Certification program for specialists

Half-yearly ESG regulatory update provided to all staff

Developed in house or by an external provider

Good practices: ECB Report Observations from the 2022 thematic review



- ECB report on the thematic review 2022, covering 107 significant institutions
- Description of 26 good practices drawn from over 25 different institutions, covering the following areas:
 - Materiality assessment
 - Business strategy
 - Governance and risk appetite
 - Risk management
- Relevant source of information also for LSIs and third-country branches





Thank you

20 June 2023