Commission de Surveillance du Secteur Financier

Circular letter CSSF

CSSF RECOMMENDATION ON RESTRICTION OF DISTRIBUTIONS DURING THE COVID-19 PANDEMIC

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Re: CSSF recommendation on restriction of distributions during the COVID-19 pandemic

Luxembourg, 22 December 2020

To all credit institutions (that are not Significant Institutions under the SSM)

Ladies and Gentlemen,

On July 30 2020, the CSSF announced its intention to comply with the ECB "Recommendation on dividend distributions during the COVID-19 pandemic" (ECB/2020/35) issued on 27 July 2020 and with the ESRB "Recommendation on restrictions of distributions during the COVID-19 pandemic" issued on 27 May 2020, as well as its endorsement of the EBA "Statement on dividends distribution, share buybacks and variable remuneration" dated 31 March 2020 (hereinafter the "EBA Statement"). In accordance with these texts, the CSSF recommended Luxembourg credit institutions to refrain from taking decisions on distributions that would constrain their bank's capacity to meet the COVID-19 induced needs for liquidity and credit of the customers in the markets they serve and/or would have the effect of reducing the quantity or quality of the bank's own funds or reducing their loss absorbing capacity for the duration of the COVID-19 related crisis until 1 January 2021.

Even with the improvement in macroeconomic conditions and the reduction of economic uncertainty due to the COVID-19 pandemic, the level of uncertainty remains elevated with a continued impact on banks' ability to forecast their medium-term capital needs. Given the ongoing public support measures and considerable delay of the impact of the economic fallout on the balance sheets of credit institutions, the full effect of the COVID-19-related economic shock on the banking sector may not have yet fully materialised. This persisting uncertainty calls for extreme prudence in the distribution policies and practices of credit institutions.

Against this background, on 15 December 2020, the EBA published a new statement on banks' distribution policies[1] (hereinafter the "EBA statement") by which the EBA continues to call on banks to apply a conservative approach on dividends and other distributions in light of the COVID-19 pandemic. The same day, the ECB published Recommendation (ECB/2020/62) on dividend distributions during the COVID-19 pandemic (hereinafter the "ECB Recommendation")[2] which repeals Recommendation ECB/2020/35 and by which the ECB recommends that until 30 September 2021 significant credit institutions exercise extreme prudence when deciding on or paying out dividends or performing share buy-backs aimed at remunerating shareholders and also advises national competent authorities to apply the same principles for LSIs. Finally, on 18 December 2020 the European Systemic Risk Board (ESRB) published a Recommendation on restriction of distributions during the COVID-19 pandemic (ESRB/2020/15) (hereinafter the "ESRB Recommendation") which amends ESRB Recommendation 2020/7. The ESRB Recommendation calls relevant authorities to request financial institutions under their supervisory remit to refrain from distributions or apply extreme caution as regards distributions until 30 September 2021 so that they do not put the stability of the financial system and the recovery process at risk. The ESRB considers that any level of distribution should be significantly lower than in the recent years prior to the COVID-19 crisis. All three authorities also reiterate their expectation that the variable remuneration of material risk takers should continue to be set at a conservative level.

The CSSF intends to comply with the ECB Recommendation, the EBA Statement and the ESRB Recommendation and remains committed to the aim of ensuring a globally coordinated response to the COVID-19 pandemic under the umbrella of the Basel Committee on Banking Supervision and the Financial Stability Board.

In this context, this circular letter provides an update of the CSSF policy on restrictions of dividend distributions and share buy-backs, considering all the above European texts, and provides guidance as well on the CSSF's expectations with regard to remuneration practices.

It is thus recommended that Luxembourg credit institutions apply the principles described in the paragraphs below.[3]

a) Dividends distribution and share buy-backs

The CSSF calls on management bodies of Luxembourg credit institutions[4] to consider not distributing any cash dividends or conducting share buy-backs until September 2021, or to limit such distributions. Banks envisaging any dividends or other distribution should carefully assess the resulting impact on their capital trajectory and avoid taking decisions that would constrain their capacity to meet the COVID-19 induced needs for liquidity and credit of the customers in the markets they serve

[1] *https://eba.europa.eu/eba-continues-call-banks-apply-conservative-approach-dividends-and-other-distributions-light-covid*

[2] *https://www.bankingsupervision.europa.eu/ecb/pub/pdf/en_ecb_2020_62_f_sign~6a404d7d9c..pdf*

[3] *For the significant supervised entities and significant supervised groups, the approach of the Single Supervisory Mechanism (SSM) applies.*

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and/or would have the effect of reducing the quantity or quality of the bank's own funds or reducing their loss absorbing capacity for the duration of the COVID-19 related crisis.

The term 'dividend' as used here refers to any type of cash pay-out in connection with Common Equity Tier 1 capital which has the effect of reducing the quantity or quality of own funds and does not include stock dividends.[5]

Luxembourg credit institutions envisaging any dividends or other distribution should apply extreme caution and prudence in carrying out any of these actions. Prudence in this context means that the CSSF will generally expect that banks with a material exposure to COVID-19 would not consider making dividend distributions and share buy-backs amounting to more than 15% of the cumulated profit for 2019-20, or more than 20 basis points in terms of the Common Equity Tier 1 (CET1) ratio, whichever is lower, as defined in the ECB Recommendation 2020/62. Banks should also refrain from distributing interim dividends out of their 2021 profits.

Luxembourg credit institutions that intend to decide on or pay out dividends or perform share buy-backs aimed at remunerating shareholders shall contact the CSSF, as part of their supervisory dialogue, to discuss whether the level of intended dividend distribution is prudent. The supervisory dialogue with banks in this context should, in particular, consider banks' income generation capacity based on prudent projections, to ensure that banks retain ample resources to withstand a possible further deterioration of asset quality while continuing to support the economic recovery and the financing of households and corporates.

In its latest Statement, the EBA considers that "ensuring the efficient and prudent allocation of capital within banking groups remains crucial and should be monitored by competent authorities. Capital distributions within a banking group should serve the need to support the local and the broader European economies as well as to ensure the proper functioning of the Single Market, particularly crucial in this time of crisis." This statement holds equally true at the level of the global financial system.

b) Variable remuneration

In line with the aforementioned ECB, EBA and ESRB communications and taking into account the aforementioned considerations, the CSSF expects credit institutions to adopt extreme moderation with regards to variable remuneration payments until 30 September 2021, especially those to material risk takers.

In that respect, credit institutions shall adopt prudent variable remuneration decisions and in doing so shall refrain from taking decisions that would create an obligation to pay variable remuneration to material risk takers, which would constrain their capacity to meet the COVID-19 induced needs for liquidity and credit of the customers in the markets they serve and/or would negatively affect the amount or quality of their institutions' total capital.

[5] *Dividend distributions solely in the form of ordinary shares are allowed provided they do not reduce the quantity or quality of own funds. Such dividend distributions should nevertheless be designed in such a way that they do not mechanically increase dividends to be paid out in subsequent years, in particular for banks expressing their dividend policy in a fix amount per share.*

In doing so, the CSSF expects credit institutions to reduce, to the extent possible, the payment of variable remuneration, which in any case should not expose the institution to litigation or legal risk, and to consider paying variable remuneration in instruments and this especially for material risk takers.

The terms ‘variable remuneration’, ‘instruments’ and ‘material risk takers’ are to be understood and used here as defined in the law of 5 April 1993 on the financial sector, in the Commission Delegated Regulation (EU) n° 604/2014 and in the EBA guidelines on sound remuneration policies (EBA/GL/2015/22).

The CSSF recommendations under points a) and b) above enter into force as of 1st January and apply until 30 September 2021.

Given the temporary nature of these measures that are related to the current exceptional circumstances, the CSSF intends, in the absence of materially adverse developments, on 30 September 2021, to repeal the recommendations and return to assessing banks’ capital and distribution plans as well their remuneration policies and practices in the context of the normal supervisory cycle.

Yours faithfully,

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