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Regulatory news alert

Regulatory key points for credit institutions and PSFs

CSSF 2014 Annual Report

Dear all,

Following the publication of the CSSF Annual Report 2015, you will find below a summary of regulatory key points for Credit institutions and PSF.

Complaints handling

CSSF Regulation N°13-02 was published in *Mémorial A N°187* of 28 October 2013. Its section 2 specifies certain obligations incumbent upon professionals regarding the handling of complaints. These provisions are applicable since 1 July 2014 to professionals subject to the prudential supervision of the CSSF and require adaptations to their internal procedures.

In order to provide clarification on the implementation of CSSF Regulation N°13-02 Section 2, the CSSF published **Circular 14/589**. On an annual basis, a table containing the number of complaints registered by the professional, shall be communicated to the CSSF. A template is provided in the Circular. These reporting requirements are compliant with the guidelines for complaints-handling for the securities (ESMA) and banking services (EBA) (**JC 2014/43**).

In its annual report, the CSSF specifies that categories may be added to the template table to correspond with the professional's activities.

Annual reporting on complaint handling must be submitted no later than 1 March of the following year.

IFRS

Principle of materiality and activities' specificity

Considering the volume and the complexity of information required by IFRS, the CSSF recommends issuers to ensure that the information presented in their financial statements is relevant, tailored to their market and activities, and thus allow their users to understand the financial position, performance and significant issues of the entity.

Fair value and disclosures

Since 1 January 2013, the information disclosed in the notes to IFRS financial statements must fulfil the requirements and objectives of IFRS 13. It must provide an understanding of the following:

- for assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements; and
- for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

The CSSF also highlights that IFRS 13 is particularly demanding in terms of disclosure requirements for assets and liabilities carried at fair value and classified as Level 3. IFRS paragraph 93 requires quantitative information on main unobservable inputs, as well as qualitative information on the sensitivity of fair value to changes of major unobservable inputs in case of significant potential impacts.

The CSSF therefore urges issuers to pay particular attention to disclosures on the fair value of their assets and liabilities.

Impairment of non-financial assets

In case goodwill or intangible assets with indefinite life represent an important part of the balance sheet, the CSSF recalls the particular importance of estimates and assumptions underlying the calculation of the value in use.

Following its 2014 review of impairment tests, the CSSF stresses that improvements were still needed for the presentation of the following information:

a) Key assumptions applied to the estimate of recoverable amounts

   The CSSF recalls that paragraph 134 of IAS 36 "Impairment of Assets" requires, for each cash-generating unit to which goodwill or significant intangible asset with indefinite life is allocated, the disclosure of:

   i. the key assumptions on which the entity has based its calculation of the recoverable amount; and

   ii. the approach to determine these key assumptions, referring in each case if the assigned value reflects past experience or concurs with external sources of information.

   The CSSF also emphasizes that in cases where the key assumptions differ from the past performance significantly, IAS 36 paragraphs 134 (d) (ii) and (e) (ii) require to explain these differences. In addition, it is important that these key assumptions are given for each significant cash-generating unit and not on aggregated basis, since this presentation could conceal significant gaps between the different units.

b) Sensitivity analysis of recoverable amounting to possible changes in assumptions

   The CSSF requires issuers to ensure the information necessary for the proper understanding of challenges in this context.

Cash-flow statements

As IAS 7 defines cash-flows from operating activities only per default, the CSSF highlights that it is particularly important that issuers pay close attention to the components they present as operating cash-flows and ensure that they do not qualify for investment or financing cash-flows.

The indirect method is commonly chosen to report cash flows from operational activities. However, adjustments for non-cash transactions are often irrelevant or presented incorrectly. The CSSF recommends the clear and accurate presentation of these adjustments (IAS 7 paragraph 20) to provide relevant information to understand the cash-flows related to operating activities. The CSSF also recalls that the direct method is encouraged by IAS 7 paragraph 19 for the main categories of inflows and outflows.

IAS 7 allows different options for the presentation of interests and dividends (operating, financial or investment cash-flows, as appropriate), the CSSF recommends to clarify the choices made. Furthermore, the CSSF specifies that these flows should be a separate and permanent presentation from one year to another in operating, investing or financing cash flows.

Interim Financial Reporting

The CSSF points out that in case of changes in the accounting or valuation methods of interim financial statements, IAS 34 requires a description of these changes and their impacts on the interim financial statements.

It also highlights that information on the fair value of financial instruments is often incomplete or missing in interim financial statements (IAS 34 paragraph 16A (j), referring to IFRS 7 and IFRS 13). The CSSF recalls also the requirement to present OCI line items which are grouped between those items that will or will not be reclassified to profit and loss in subsequent periods.

Issuance of debt instruments

The CSSF calls attention of the entities the main activity of which is financing through the issuance of debt instruments on the quality of information required. It highlights the following weaknesses:

- Lack of information updates according to the occurred changes (e.g. fair value of significant transactions, market conditions, etc.);
- Quality of information on valuation techniques (insufficient or too specific); and
- Relevance of the information on risks (IFRS 7 paragraph 31). For each type of risk (credit risk, liquidity risk, market risk, concentration risk, etc.), the CSSF expects that issuers provide qualitative and quantitative information adequate and adapted to the specificities of their financial instruments and to the industry in which they operate.

2015 review

The CSSF will notably focus on the following:

- Application of the requirements of IAS 34 Interim Financial Reporting;
- Consolidation exemption under IFRS 10 Consolidated Financial Statements; and
- Recognition of Deferred Tax Assets as per IAS 12.

Risk Management

ICAAP

Following its work performed in 2014 on ICAAP reporting, the CSSF requested a more detailed description for the following areas:

- Stress tests and their conclusions in the daily management;
- Treatment of risk concentration, including indirect concentrations resulting from risk mitigation techniques;
- Crisis management plans for own funds and liquidity; and
- Definition of risk appetite.

Description shall reflect adequately the specificity of bank business model and all inherent risks.

Operational Risk

For banks applying the AMA, the CSSF emphasizes the importance of an active and reactive management of the operational risk in Luxembourg. Beyond the implementation of a model generally set by the group, the capital allocated to operational risk shall be properly analysed, argued and justified according to its suitability with operations of the Luxembourg entity.

Supervision on a consolidated basis

The CSSF puts forward especially the way the Luxembourg parent company communicates its policies and strategies to its subsidiaries and the controls in place in order to monitor the organisation and activities of subsidiaries and risks incurred by them.

In the context of its supervision on a consolidated basis, the CSSF expects to obtain systematically from the supervised banks and financial holding companies subject to consolidated supervision information on the interventions of host country supervisory authorities to their subsidiaries when these interventions focus upon the failure to comply with local regulations and the organisational aspects or risks of these subsidiaries.

Investment firms

Capital base

The CSSF points out that a subordinated loans or benefits of the current year are not to be taken into account for the determination of the minimum capital base of a PSF.

Specialised PSFs

Capital base

The CSSF recalls the rules of Article 20 paragraph 4 of the Law of 5 April 1993 on financial services, stating that the capital shall be kept at the permanent disposal of the PSF and invested in its own interest. Moreover, it is specified that "[...] the first requirement is to ensure that the capital base will not be locked in participations or providing credit. The second requirement is to ensure the capital base is used in the interest of the PSF and its customers and not its shareholders or its group".

In this context, the CSSF emphasizes that the funds invested in a participation are to be deducted from the PSF capital base.

Compliance of daily management

The CSSF recalls the principle of dual management pursuant to Article 19 paragraph 2 of the Law of 5 April 1993 on financial services. It allows mutual control and collegiate decisions to the daily management with at least two delegates who shall be empowered in practice to determine the orientation of the activity of the specialised PSF because they are jointly and directly responsible for the effective, sound and prudent management of all activities performed and the risks involved.

Loan granting

The CSSF recalls that due to prudential considerations, a specialized PSF cannot grant loans to its shareholders, officers, employees or third parties.

Support PSFs

Evolution of the Risk Assessment Report (RAR)

In order to improve the consistency and the comparability of RARs, the CSSF planned RAR developments by setting up a dual strategy: firstly, continue to work together with support PSFs on improving the quality of RAR and, secondly, introduce a risk classification by status and activity by developing risk repositories. Therefore, the CSSF wishes to develop standards tailored to each status and each activity to focus only on the most relevant operational risks. Risk repositories will draw heavily from international norms and standards in terms of information systems security, such as ISO standards. This new more prescriptive approach will be supported by a software tool.

The CSSF informs that a new circular replacing Circular 12/544 should be published in early 2016. Until the publication of this new circular, support PSFs shall report in accordance with the current procedure. The CSSF asks support PSFs to consider the comments and recommendations issued in its activity report and observation letters.

Supervision of information systems

Authorisation

CSSF recalls that the quality of application file for authorisation is essential for an effective instruction. The CSSF will shortly publish on its website an updated form specifying the information and the documents required for the IT section.

Use of external mailbox for the transmission of financial operations orders to be executed

The CSSF reiterates its advice for increased vigilance concerning the use of internet mailbox to transmit financial trade orders, as mentioned in the 2013 Annual Report Chapter XI item 2.3. Financial professionals cannot be sure of the legitimacy of the message received and fraud cases were identified in 2014 in this context.

The CSSF considers that a financial professional should not offer its customers this communication channel for the transmission of sensitive instructions. Financial professionals should require that a specific convention is signed with customers, informing them of the risks associated with this type of communication and to put in place controls designed to check the veracity and origin of emails (e.g. the manager contacts the customer by phone to confirm the order).

Confidentiality and outsourcing

CSSF puts the emphasis on the rules defined in the 2013 Annual Report by Chapter XI, 2.3., concerning the obligation to guarantee the confidentiality of customer information.

Regardless of the confidentiality issue, the CSSF recalls that financial institutions have to decide whether, based on their own risk analysis, they entrust sensitive information on their IT infrastructure outsourced to a third party.

We trust this information is of assistance and remain at your disposal for any further questions.

Your contacts

Martin Flaunet
Partner | Banking & Securities Leader
Tel/Direct: +352 451 452 334
mflaunet@deloitte.lu

Stéphane Césari
Partner | PSF Leader
Tel/Direct: +352 451 452 487
scesari@deloitte.lu

Anne-Françoise Liégeois
Director | Regulatory Watch
Tel/Direct: +352 451 452 536
afliegeois@deloitte.lu

Emmanuelle Caumont
Senior manager | Regulatory Watch
Tel/Direct: +352 451 452 086
ecaumont@deloitte.lu

Deloitte Luxembourg
560, rue de Neudorf
L-2220 Luxembourg

Tel: +352 451 451
Fax: +352 451 452 401
www.deloitte.lu

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