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Luxembourg

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Introduction

As a leading financial centre in the European Union (the **EU**), Luxembourg offers a diverse range of financial services that connect investors and markets around the world. Luxembourg is a cross-border centre in banking, being home to 120 international banks as at 30 November 2022 providing direct jobs to approximately 26,000 people. In the 2022 Global Financial Centres Index, Luxembourg was ranked as having the 21st most competitive financial centre in the world. With approximately a quarter of Luxembourg's economy depending on financial services, the significance of the financial sector also results in the development of financial regulation being an important policy consideration for the Luxembourg legislator.

Recent trends in the context of the Ukraine conflict

Following the Russian invasion of Ukraine, the Council of the EU adopted restrictive measures against Russia and Belarus, which required the financial sector to, *inter alia*, enhance its internal controls and governance to meet the relevant supervisory expectations applicable to their operations. On 11 March 2022, the European Banking Authority (the **EBA**) published a supervisory statement calling financial institutions to take all necessary action to ensure compliance with sanctions and other restrictive measures as well as to facilitate refugees' access to payment accounts following the activation of the EU's Temporary Protection Directive, introducing temporary protection and support to persons fleeing Ukraine as a consequence of the war.

Despite the challenge of the Russo-Ukrainian war, the financial sector of Luxembourg has shown its resilience and stability. Contrary to the financial crisis of 2008, banks are considerably stronger and in a much better liquidity position than 15 years ago. The extensive legal framework introduced since 2008 provides for a stable framework to offer a way out of the current crisis. From a prudential oversight point of view, banks have been able to withstand the economic shock of the ongoing geopolitical conflict. Luxembourg remains attractive to global financial firms despite the general trend of consolidation sweeping across the European banking industry.

Further, as a trustworthy hub and reliable jurisdiction for international finance, Luxembourg benefitted from the relocation of certain United Kingdom-based entities willing to continue to operate within the EU and to insulate themselves from the effects of Brexit.

Recent trends relating to digitalisation

The Luxembourg legislator's positive take on digital development has led to recent national legislative initiatives relating to the use of digital innovations in the financial sector. It is worth noting that in line with the positioning of Luxembourg as a Fintech hub and in order to face the challenges of technological innovation in the financial sector, the financial sector

supervisory commission (*Commission de Surveillance du Secteur Financier*, the **CSSF**) has recently created an Innovation Hub, a dedicated point of contact for any person wishing to present an innovative project or to exchange views on the major challenges faced in relation to financial innovation in Luxembourg. Furthermore, the CSSF collects guidance and publications on a national and international level related to specific areas of Fintech, such as virtual assets, artificial intelligence, robo-advice and crowdfunding. Against this background, the CSSF develops insights into the prudent management of, among others, ICT-related risks, which will stand the CSSF in good stead for when overseeing compliance of the financial sector with the regime stemming from the Digital Operational Resilience Act (**DORA**) that entered into force on 16 January 2023 and by which the European Commission aims to ensure that financial services will remain competitive in the digital age.

Sustainable finance driving change in the financial sector

Sustainable finance continues to play a significant role in the Luxembourg financial sector. The recent adoption by the European Commission of regulatory technical standards under the SFDR (as defined below) as well as the integration of clients' sustainability preferences into suitability assessments, together with the integration of sustainability objectives into product governance under MiFID II (as defined below), demonstrate the EU's emphasis on sustainable finance in addition to the global growing sustainability concerns and transition of the financial sector towards sustainability. Being home to the Luxembourg Green Exchange, the world's first dedicated and leading platform for green, social and sustainable securities launched in 2016, and having the largest market share of listed green bonds worldwide, Luxembourg is a leading green finance centre, as confirmed by the last edition of the Global Green Finance Index published in October 2022, which ranked Luxembourg in second place in the EU and fourth place globally.

Regulatory architecture: Overview of banking regulators and key regulations

National level

The national authorities responsible for the regulation and supervision of the banking sector in Luxembourg are the CSSF and the Central Bank of Luxembourg (the **BCL**), which are placed under the authority of the Ministry of Finance.

The CSSF

The CSSF is the authority responsible for the prudential supervision of the Luxembourg financial sector. Since 30 July 2021 and the entry into force of the so-called "Authorisation Law" of 21 July 2021, the CSSF is solely competent for granting, refusing and withdrawing authorisations of certain entities placed under its supervision (being, among others, mortgage credit intermediaries, credit institutions, investment firms, specialised professionals of the financial sector, support professionals of the financial sector, payment institutions and electronic money institutions, branches of foreign professionals of the financial sector other than investment firms, branches of third-country credit institutions, and third-country firms providing investment services or performing investment activities). Before the entry into force of the aforementioned Law, the granting, refusing and withdrawing authorisation for such authorised institutions was under the authority of the Ministry of Finance. The shifting of such competences reflects the evolution of the EU laws increasingly advocating the allocation of powers of approval to the national competent authorities in charge of prudential supervision. Further, the CSSF is the (i) national resolution authority for the resolution of credit institutions and certain investment firms in the framework of the Single Resolution Mechanism and the Single Resolution Fund under EU Regulation 2014/806

of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending EU Regulation 2010/1093 of 24 November 2010, and (ii) resolution authority of failing national or transnational banks with the view to limiting their systemic impact as provided by the law of 18 December 2015 on the failure of credit institutions and certain investment firms (transposing EU Directive 2014/59 of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, as amended by Directive (EU) 2019/879 of 20 May 2019 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC (the **BRRD Package**)).

Further, the CSSF is the competent authority for the application of Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC (**Prospectus Regulation (EU) 2017/1129**) and the law of 16 July 2019 on prospectuses for securities that implements certain provisions of Prospectus Regulation (EU) 2017/1129, and provides for other requirements covering the national prospectus regime.

Its field of competence also encompasses the control of professional obligations regarding anti-money laundering and combatting the financing of terrorism (**AML/CFT**).

The CSSF is also in charge of the supervision of markets in financial instruments and their operators.

The BCL

The BCL is part of the European System of Central Banks and is specifically responsible for, *inter alia*: (i) the supervision of liquidity of credit institutions, in cooperation with the CSSF; (ii) control over the smoothness and efficiency of payments systems; (iii) the empowerment of financial stability; and (iv) the implementation of monetary policies.

The CAA

Credit institutions that are authorised to pursue insurance-related activities are also supervised for such activities by the *Commissariat aux Assurances* (the **CAA**), the authority that regulates and supervises the insurance, insurance mediation, reinsurance and management of complementary pension funds activities.

The influence of supra-national regulatory regimes or regulatory bodies

EU level

As part of the European Banking Union, the Luxembourg banking system is subject to the supervision of the European Central Bank (the **ECB**) within the framework of the European Single Supervisory Mechanism (the **SSM**). The ECB is specifically responsible for: (i) granting and withdrawing banking licences; (ii) assessing banks' acquisitions and disposals of qualifying holdings; (iii) ensuring compliance with EU prudential and governance requirements; (iv) conducting supervisory reviews, on-site inspections and investigations; and (v) setting higher capital requirements ("buffers") in order to counter any financial risks.

Since November 2014, the ECB is exclusively competent for granting licences, approvals of qualifying holdings and appointment of key function holders in all significant credit institutions, established in the Member States participating in the SSM. The ECB's role in such significant credit institutions includes the supervision of solvency, liquidity and internal governance.

It is worth noting that the supervision of less-significant institutions incorporated under Luxembourg law and branches of non-EU institutions remains under the scope of competence of the CSSF. Further, the CSSF remains the main authority for the supervision of, among others, (i) compliance with professional obligations regarding AML/CFT, and (ii) regulations for consumer protection.

The key legislation and regulation applicable to banks in Luxembourg

The principal rules and regulations applicable to the financial and banking sector are embodied in the law of 5 April 1993 on the financial sector, as amended (the **LFS**), which implements, among others, EU Directive 2013/36 of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (**CRD IV**), as recently amended by Directive (EU) 2019/878 of 20 May 2019 as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (**CRD V**). Notably, the LFS regulates: (i) authorisation of credit institutions and access to professional activities in the financial sector; (ii) professional obligations, prudential rules and rules of conduct; (iii) prudential supervision of the financial sector; (iv) prudential rules and obligations in relation to recovery planning, intra-group financial support and early intervention; and (v) the power of the CSSF to impose fines and sanctions.

In addition to the LFS, the main laws and regulations that govern banking activities in Luxembourg include the following:

- the law of 20 May 2021 transposing CRD V (the **CRD V Law**) and amending, among others, the LFS;
- EU Regulation 2013/575 of 26 June 2013 on prudential requirements for credit institutions and investment firms (the **CRR**, together with CRD IV commonly referred to as the **CRD IV Package**);
- EU Regulation 2019/876 of May 2019 amending EU Regulation 2013/575 of 26 June 2013 on prudential requirements for credit institutions and investment firms (the **CRR II**, together with CRD V commonly referred to as the CRD V Package and together with the CRD IV Package, the **EU Banking Rules**);
- EU Regulation 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector (the **SFDR**);
- EU Regulation 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending EU Regulation 2019/2088 (the **Taxonomy Regulation**);
- the law of 30 May 2018 on markets in financial instruments transposing, among others, the MiFID Framework (as defined below) (the **MiFID Law**);
- the law of 18 December 2015 on the resolution, reorganisation and winding-up measures of credit institutions and certain investment firms and on deposit guarantee and investor compensation schemes implementing the BRRD Package, as amended;
- the law of 8 December 2021 on the issuance of covered bonds, which, among other things, (i) transposed EU Directive 2019/2162 of 27 November 2019 on the issue of covered bonds and the public supervision of covered bonds amending Directives 2009/65/EC and 2014/59/EU, and (ii) implemented EU Regulation 2019/2160 of 27 November 2019 amending EU Regulation 575/2013 as regards exposures in the form of covered bonds;
- the law of 10 November 2009 on payment services, as amended;
- the law of 12 November 2004 on the fight against money laundering and terrorist financing, as amended (the **AML/CFT Law**), which implemented the latest provisions introduced by Directive (EU) 2015/849 of 20 May 2015 and Directive (EU) 2018/843

of 30 May 2018 (commonly referred to, respectively, as the Fourth and Fifth AML Directives);
- the law of 23 December 1998 establishing the CSSF; and
- the law of 17 June 1992 on annual and consolidated accounts of credit institutions, as amended.

Further, being a member of the Eurozone, regulation of the banking sector in Luxembourg is also subject to specific pieces of Eurozone legislation, including regulations and directives transposed into national law and guidelines provided by the EBA. In this respect, EBA Guidelines EB/GL/2015/20, to be read in conjunction with CSSF Circular 16/647, on limits on exposure to shadow banking entities that carry out bank-like activities outside a regulated framework (and developed in accordance with article 395(2) of the CRR), should be mentioned. The EBA Guidelines apply to all institutions subject to part four (Large Exposures) of the CRR, which shall comply with the aggregate exposure limits or tighter individual limits set on exposures to shadow banking entities carrying out banking activities outside a regulated framework (including special-purpose vehicles engaged in securitisation transactions).

From the international level, Luxembourg is influenced by supra-national regulatory regimes and regulatory bodies. Moreover, Luxembourg is a Member State of (i) the Organisation for Economic Co-operation and Development (the **OECD**), establishing norms and better policies for a wide range of subjects, such as corruption and tax avoidance, and (ii) the Financial Action Task Force, which sets standards and recommendations and promotes effective implementation of legal, regulatory and operational measures for the fight against money laundering and terrorist financing.

In addition, the CSSF is one of the bank supervisors that are members of the Basel Committee on Banking Supervision, the primary global standard-setter for the prudential regulation of banks.

The European Commission, the ECB and the OECD are members of the Financial Stability Board (the **FSB**), which is an international organisation that monitors and makes recommendations for the global financial system and has a direct impact on domestic banking legislation.

Finally, the Luxembourg regulatory framework applicable to banks is complemented by Grand Ducal regulations, Ministerial regulations and CSSF regulations and circulars issued by the CSSF on various matters related to the financial sector with a view to providing more guidance on how legal provisions should be applied and issuing recommendations on conducting business in the financial sector. Of particular relevance is CSSF Circular 12/552 on the central administration, internal governance and risk management of banks and professionals performing lending operations, as amended.

Recent and proposed changes to the regulatory architecture in Luxembourg

Recent changes to the regulatory architecture

It is worth noting that changes to the regulatory architecture are mainly driven by initiatives taken at the EU and international levels. The following is an overview of the most recent changes affecting the banking regulatory architecture in Luxembourg.

Sustainability-related disclosures in the financial services sector

Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022, supplementing the SFDR with regard to regulatory technical standards clarifying the content and presentation of sustainability-related disclosures in the financial services sector, has been adopted and applied

as from 1 January 2023. Accordingly, banks that provide portfolio management shall make a statement that they consider principal adverse impacts (**PAIs**) of their investment decisions on sustainability factors and describe both the relevant PAIs together with the policies on the basis of which the identification of such PAIs is effected. In addition, banks that provide investment advice shall explain in their PAI statement, which is to be published on their website, whether they rank and select financial products on the basis of the PAI indicators, including how they use the information made available by financial market participants as well as any other criteria that are used to select, or advise on, financial products.

In the context of the Taxonomy Regulation (as defined below), which establishes six environmental objectives, the European Commission has to provide lists of environmentally sustainable activities by defining technical screening criteria for each environmental objective through delegated acts. To that end, Commission Delegated Regulation (EU) 2022/1214 of 9 March 2022 has been adopted, laying down, under strict conditions, specific nuclear- and fossil gas-related activities to be covered by the EU Taxonomy. Accordingly, as of 1 January 2023, banks are required to disclose whether the financial products invest in nuclear energy and/or fossil gas.

As of 2 August 2022, pursuant to Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565, banks that provide portfolio management or investment advice will be required to consider clients' sustainability preferences in their suitability assessments. In addition, pursuant to Commission Delegated Directive (EU) 2021/1269 of 21 April 2021 amending Delegated Directive (EU) 2017/593, banks must integrate sustainability factors into their product governance requirements under MiFID II. To that end, the Grand Ducal Regulation of 27 July 2022 amended the Grand Ducal Regulation of 30 May 2018 on the protection of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits for the purpose of transposing Delegated Directive (EU) 2017/593. Accordingly, as of 22 November 2022, the new product governance requirements are applicable to banks that act either as manufacturers or distributors of financial instruments and investment services.

Regulatory developments relating to crowdfunding

Regulation (EU) 2020/1503 of 7 October 2020 on European crowdfunding service providers for business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937 (the **Crowdfunding Regulation**), entered into force on 10 November 2021. It introduces uniform requirements for the provision of crowdfunding services, the organisation, authorisation and supervision of crowdfunding service providers and the operation of crowdfunding platforms with the aim of providing access to finance for small and medium-sized enterprises underserved or not covered by the traditional banking system. The Crowdfunding Regulation was incorporated into national law by the law of 25 February 2022, which entered into force on 8 March 2022.

Proposed changes to the regulatory architecture

On 1 June 2022, the law of 30 March 2022 on inactive accounts, inactive safe deposit boxes and unclaimed life insurance contracts entered into force. Through this law, Luxembourg intends to provide itself with a specific legal framework in this area, following the examples of France and Belgium. The law sets out measures aiming to prevent account inactivity, introduces a mandatory consignment procedure following prolonged inactivity, and lays down provisions with a view to facilitating the restitution process for account holders, beneficiaries or their heirs by introducing a centralised electronic register. Accordingly,

banks must put in place internal processes to monitor and identify potential inactive accounts as well as rules to search and inform the holders of these accounts or, as the case may be, their beneficiaries. Similar rules apply to banks when handling inactive safe deposit boxes.

Regulatory development related to DLT market infrastructures

On 2 June 2022, Regulation (EU) 2022/858 of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology (**DLT**) was published in the Official Journal of the EU. The Regulation lays down requirements in relation to DLT market infrastructures and their operators with respect to, among other things, granting and withdrawing specific permissions to operate DLT market infrastructures, operating and supervising DLT market infrastructures as well as enabling such entities to be exempted from other requirements under EU directives or regulations, including the MiFID Framework. The Regulation further sets out qualitative and quantitative limitations on in-scope financial instruments, which include shares, bonds and units in collective investment undertakings. Given that crypto-assets are one of the main applications of DLT in the financial sector, the Regulation aims at helping to identify a suitable set of financial services legislation to enable the full deployment of such crypto-assets and their underlying technology.

Recent regulatory themes and key regulatory developments in Luxembourg

Change to the regulatory regime following the financial crisis

European banking regulation has undergone a continuous evolution since the financial crisis of 2008 and the adoption of a certain number of directives and regulations as a response to the financial crisis. The main legislation taken in this respect could be summarised as follows:

- CRD IV;
- the CRR;
- EU Regulation 2013/1024 of 15 October 2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions, and EU Regulation 2013/1022 of 22 October 2013 amending EU Regulation 2010/1093 of 24 November 2010 establishing a European supervisory authority (the EBA) as regards the conferral of specific tasks on the ECB pursuant to EU Regulation 1024/2013, together establishing the SSM; and
- EU Regulation 2014/806 of 15 July 2014, as amended, establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending EU Regulation 2010/1093, and the BRRD, together establishing the Single Resolution Mechanism.

These regulations were part of a logic of risk reduction in the banking sector within the EU and the Eurozone. The gradual establishment of a Banking Union at the EU level with its unique supervision and resolution mechanisms marked the starting signal for risk pooling through the establishment of euro area-wide safety nets, including the Single Resolution Fund.

Most of the above legislative texts have already been amended with the CRD V and BRRD II Packages and are subject to further amendments following the European Commission's adoption, on 27 October 2021, of a review of the EU Banking Rules. The new CRD V Law amending the LFS, introducing novel concepts, is analysed in subsequent sections.

Regulatory developments relating to Brexit

On 14 December 2020, the CSSF published Regulation 20-09 amending CSSF Regulation 20-02 of 29 June 2020 on the equivalence of certain third countries with respect to

supervision and authorisation rules for the purpose of providing investment services or performing investment activities and ancillary services by third-country firms. As specified in the CSSF press release of 24 December 2020, the Regulation includes the United Kingdom of Great Britain and Northern Ireland in the list of jurisdictions deemed equivalent for the application of the national third-country regime.

Regulatory developments relating to Fintech

The Luxembourg legislator has taken significant initiatives in the area of digitalisation of banking and financial activities and more specifically in the implementation of technological innovations in the field of capital markets. Two distinct laws passed in 2019 and 2021 allowed the use of new technologies in the issuance, holding and circulation of securities.

The law of 1 March 2019 (the **Blockchain I Law**) amended the law of 1 August 2001, as amended (the **General Securities Law**), allowing the use of secure electronic mechanisms for the holding and circulation of securities. The Blockchain I Law represented a milestone in the digitalisation of capital markets in Luxembourg as it acknowledged, for the first time, the issuance of security tokens, a specific category of crypto-assets defined in the parliamentary works as assets stored in a blockchain that represent the securities.

In an effort to extend and refine the scope of application of the Blockchain I Law, the Luxembourg Parliament passed the law of 21 January 2021 (the **Blockchain II Law**), which amended the law of 6 April 2013, as amended (the **Dematerialised Securities Law**) and the LFS, as amended. The Blockchain II Law extended the possibility to use secured electronic registration systems, such as DLT and databases, to the issuance of dematerialised securities. Following the Blockchain II Law, EU credit institutions and investment firms are allowed to take the role of central account keeper, and to hold and manage securities issuance accounts with such technologies through secured electronic registration systems such as DLT (e.g., blockchain) and databases.

The Blockchain I and II Laws filled a gap in a fundamental area of the Luxembourg legal framework, providing legal certainty to financial market participants and making the Luxembourg environment Fintech-oriented. By implementing the principle of digital neutrality, the legislator acknowledged not only the use of digital ledger technologies such as blockchain, but created an open-ended system enabling the smooth introduction of future technological developments in the securities market.

In parallel with the legislative initiatives, the CSSF regularly publishes documents to communicate its position related to financial innovation to both the public and the industry. Against this background, on 29 November 2021, the CSSF published a Communication entitled "CSSF guidance on virtual assets", which was followed by an FAQ on virtual assets for credit institutions (the **FAQ-CI**) that will be regularly updated. The aim of the recent publications is to inform professionals of the financial sector interested in getting involved with tokens of their responsibilities to: (i) carry out a thorough due diligence for the purpose of weighing up the risks and benefits before engaging with a virtual assets activity; (ii) develop both a business and a risk strategy when involved in virtual assets activities; and (iii) keep up with regulatory developments with a particular focus on the prudential treatment of virtual assets. Taking a proactive stance in anticipation of regulatory developments at the EU level, including the proposed Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937 (the **MiCA Regulation Proposal**), the CSSF communicated its expectation that credit institutions that facilitate investments in virtual assets set up an effective investor protection framework. In addition, according to the FAQ-CI, any credit institution intending to offer virtual asset services shall submit in advance a detailed business case to the CSSF including a risk-benefit

assessment, required adaptations to its governance and risk management frameworks, the effective handling of counterparty and concentration risk, and the implementation of investor protection rules.

The CSSF also constantly monitors the Fintech sector, communicating the benefits and warning of the risks associated with the use of technologies in the financial sector. In this respect, on 21 January 2022, the CSSF published a white paper on DLT and blockchain that provides market participants with, among other things, use-case examples as well as key governance and technical risks related to DLT. Among the examples of use-cases, the proposed use of DLT to confirm an identity claim through cryptographic proof is particularly relevant for banks in the context of carrying out customer due diligence for the purpose of complying with their professional obligations arising out of the AML/CFT Law. In addition, on 27 April 2022, the CSSF released new guidance to the attention of consumers who are exposed to promotion campaigns for investments in virtual assets via, among others, social media platforms that highlight the possibility of high returns. Instead of user-friendly platforms, the CSSF recommends that consumers engage with regulated entities. Finally, it is worth noting that, following the entry into force of the law of 25 March 2020 implementing the Fifth AML Directive and amending the AML/CFT Law, no virtual asset service provider may be established in Luxembourg without being registered with the CSSF.

Bank governance and internal controls

Key requirements set out in the LFS relating to the central administration and internal controls of credit institutions are specified in CSSF Circular 12/552, as amended. In a nutshell, Luxembourg regulation requires credit institutions to have robust internal governance arrangements, effective risk management processes, adequate internal control mechanisms, sound administrative and accounting procedures, remuneration policies and practices allowing and promoting sound and effective risk management, as well as control and security arrangements for information processing systems.

More precisely, the following general requirements apply to boards of directors of banks, committees, remuneration and internal control.

Management and central administration

The central administration of a credit institution must be established in Luxembourg. The authorised management of credit institutions must be composed of at least two members (the so-called "four-eyes principle") who must be empowered to effectively direct the business. The managers must produce evidence of their professional repute. In addition, they must have already acquired an adequate level of professional experience through the performance of similar activities and assessed on the basis of a *curriculum vitae* and/or any other relevant evidence. The good repute of the members of the bodies performing administrative, management and supervisory functions is assessed on the basis of police records and any evidence that shows that the persons concerned have a good reputation and offer every guarantee of irreproachable conduct. The prudential approval procedure sets out the fit and proper approval process for the appointment of key function holders and members of the management body in credit institutions. Recent amendments to CSSF Circular 12/552 have enhanced the provisions with respect to the diversity and independence of the management body.

Committees

Banks may be required to put in place various committees, such as an audit committee or a risk committee, which oversee certain areas of the bank's operations. The obligations relating to committees depend on the size and scale of the bank.

Remuneration policies

The aim of the procedures and arrangements implemented in relation to remuneration is to help ensure that risks are managed in an efficient and durable manner. Credit institutions must comply with the requirements concerning the governance arrangements and remuneration policies of CRD IV and CRD V, as transposed into the LFS. Furthermore, credit institutions must comply with the disclosure requirements of the CRR, the criteria set out in the relevant EU regulatory technical standards, the EBA Guidelines on remuneration policies and best practices, and the applicable CSSF circulars. The CRD V Law introduced some novel provisions. Most importantly, the rules governing the remuneration policy may henceforth apply on a consolidated, sub-consolidated or solo basis, depending on specific parameters. Furthermore, the above rules apply to all employees whose activities have a material impact on the risk profile of a given credit institution, and not only to the management body. The content of the latter term is defined in article 38-5(2) of the LFS, which should be read in conjunction with Commission Delegated Regulation (EU) 2021/923. Smaller and non-complex institutions benefit from some waivers concerning the application of a limited number of remuneration requirements. At the same time, the CRD V Law recognised and implemented for the first time the gender-neutral nature of the remuneration policy. Further, credit institutions are also required to comply with obligations relating to disclosure of their remuneration policy deriving from the CRR II.

Internal control environment

CSSF Circular 12/552, as amended, requires banks to have dedicated internal control functions, such as a risk control function, a compliance function and an internal audit function. The internal control functions are permanent and independent functions, each with sufficient authority. The degree of the measures required is subject to the principle of proportionality, meaning that more complex, riskier and significant institutions must have in place enhanced internal governance and risk management arrangements.

Luxembourg regulation requires that the organisation chart of the credit institution is established based on the principle of segregation of duties, pursuant to which the duties and responsibilities will be assigned so as to avoid making them incompatible for the same person. The goal pursued is to avoid conflicts of interest and to prevent a person from making mistakes and irregularities that would not be identified. In the context of mitigating conflicts of interest, the CRD V Law requires the management body of credit institutions to document data related to loans provided to the management body and share these data with the CSSF upon its request.

Outsourcing of functions is generally permitted under the conditions laid down in the LFS and relevant CSSF circulars. However, outsourcing must not result in non-compliance with the rules of CSSF Circular 12/552 as amended and, in particular, the newly issued CSSF Circular 22/806 on outsourcing arrangements that includes both ICT and cloud outsourcing, by means of which the CSSF adopted and integrated, among others, the revised EBA Guidelines (EBA/GL/2019) on outsourcing arrangements (the **Circular OS**). Accordingly, as of 30 June 2022, all outsourcing arrangements will have to comply with the general requirements laid down in Part I of the Circular OS, while ICT outsourcing arrangements will also have to meet the specific requirements laid down in Part II thereof. The general outsourcing requirements include, *inter alia*, that the outsourcing institutions comply with the following requirements: (i) outsourcing arrangements, such as the concentration risk posed by outsourcing critical or important functions to a limited number of service providers, shall not create undue operational risks; (ii) the institution retains the necessary

expertise to effectively monitor the outsourced services or tasks; (iii) the institution ensures protection of the data concerned in accordance with Regulation (EU) 2016/679 of 27 April 2016 on General Data Protection; and (iv) the institution applies the relevant provisions of the LFS on professional secrecy. Outsourcing does not relieve the institution of its legal and regulatory obligations or its responsibilities to its customers. Furthermore, the final responsibility or the management of risk shall lie with the outsourcing institution, while the institution shall establish an outsourcing policy and maintain an outsourcing register recording all outsourcing arrangements. In addition to the general requirements, Circular 21/785, amending Circular 12/552, replaced the obligation of prior authorisation with that of notification to the CSSF with regard to outsourcing of a critical or an important function while there are no specific formalities in place with regard to outsourcing of non-critical or non-important functions.

Bank capital requirements

The regulatory capital and liquidity regime currently applicable to banks in Luxembourg derives mainly from the EU Banking Rules and numerous underlying local regulations, circulars and circular letters adopted by the CSSF. It is worth noting that following the procyclical mechanisms that contributed to the origin of the financial crisis of 2008, the FSB, the Basel Committee on Banking Supervision and the G20 made recommendations to mitigate the procyclical effects of financial regulation. In December 2010, the Basel III Framework, which consisted of new global regulatory standards on bank capital adequacy, was issued by the Basel Committee on Banking Supervision. In June 2013, the Basel III Framework was implemented into the CRR/CRD IV Package at the EU level. As stated above, the CRD IV Package has been amended by the CRD V Package.

Capital and liquidity requirements

Share capital

Credit institutions in Luxembourg are required to have a subscribed and fully paid-up share capital of at least €8.7 million. The capital base cannot be less than the amount of the prescribed authorised capital.

Own funds

In addition to the share capital requirement, credit institutions must maintain and satisfy at all times a total capital ratio of 8% of their risk-weighted assets, composed of 4.5% of Common Equity Tier 1 capital (**CET1**) (as defined in the CRR), 1.5% of Additional Tier 1 capital (as defined in the CRR), and 2% of Tier 2 capital (as defined in the CRR). The above minimum capital requirements are part of the so-called Pillar 1 of the Basel III Framework (**P1R**). As specified in the LFS and CSSF Regulation 15-02, as amended, the CSSF is capable of imposing bank-specific capital requirements (Pillar 2 Requirements – **P2R**) that have micro-prudential considerations and apply in addition to, and cover risks that are underestimated or not covered by, P1R. Both P1R and P2R are binding and obligatory for credit institutions, which is not the case for the Pillar 2 Guidance rules (**P2G**), which constitute suggestions of the CSSF to the banks relating to their own funds. The CRD V Law has clarified the relationship between P2R and P2G.

In addition to other own funds requirements, credit institutions in Luxembourg are required to hold and maintain the following buffers:

- a capital conservation buffer of CET1 equal to 2.5% of their total risk exposure amount;
- an institution-specific countercyclical capital buffer of CET1 (equivalent to their total risk exposure). The CSSF is responsible for setting the countercyclical buffer rates

applicable in Luxembourg on a quarterly basis. According to CSSF Regulation 22-08 of 31 December 2022, a countercyclical capital buffer rate of 0.5% applies to credit institutions for the first quarter of 2023;

- a Global Systemically Important Institutions (**G-SII**) buffer, being a mandatory capital surcharge built up of CET1 and applied at the consolidated level of the identified banking groups' additional capital requirements for systemically important banks. The capital surcharge may vary between 1% and 3.5% depending on the degree of systemic importance of the relevant bank. According to publicly available information, there is no bank established in Luxembourg identified as a G-SII;
- an Other Systemically Important Institutions (**O-SII**) buffer applied on a consolidated/sub-consolidated or solo basis. In this respect, the CSSF takes its decisions after consultation with the BCL and after requesting the opinion of the *Comité du Risque Systémique*. The O-SII buffer may reach up to 3% or even surpass this threshold if the European Commission's authorisation has been granted. The CSSF and the BCL have jointly developed a calibration methodology designed to translate the systemic importance of the institutions into O-SII buffer rates; and
- a systemic risk buffer for systemic banks of at least 1% based on the exposures to which the systemic risk buffer applies, which may apply to exposures in Luxembourg as well as to exposures in third countries. The rationale of this buffer, as clarified in the CRD V Law, is the mitigation of systemic risks, to the extent that these are not already covered by the capital buffers for systemically important institutions (G-SIIs/O-SIIs) or the countercyclical capital buffer. No maximum limit applies to this buffer.

Liquidity and funding requirements

In order to ensure the stability of financial institutions, the following liquidity and funding standards (adopted in the EU and designed to achieve two separate but complementary objectives) apply to credit institutions in Luxembourg:

- a Liquidity Coverage Ratio, which aims to improve the short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for 30 days. Financial institutions are required to hold at all times liquid assets, the total value of which equals, or is greater than, the net liquidity outflows that might be experienced under stressed conditions over a short period of time (30 days). Net cash outflows must be computed on the basis of a number of assumptions concerning runoff and drawdown rates; and
- a Net Stable Funding Ratio (**NSFR**), which aims to ensure the resilience of financial institutions over a longer time horizon of one year by promoting a sustainable maturity structure of assets and liabilities. Financial institutions are required on an ongoing basis to raise stable funding at least equal to their stable assets or illiquid assets that cannot be easily turned into cash over the following 12 months. Following the amendment of the CRR by the CRR II, the NSFR is applicable to all credit institutions as of 28 June 2021.

Compliance with the rules relating to bank capital and liquidity requirements is under the control of the CSSF and the ECB. In addition, financial institutions are subject to periodic reporting requirements.

As a response to COVID-19, the EU adapted its requirements relating to the CRR. By introducing EU Regulation 2020/873 of 24 June 2020 amending the CRR and CRR II, applicable since June 2020, the EU legislator introduced, among other changes, an extension by two years of the transitional arrangements for International Financial Reporting Standard 9, and the deferred application of the leverage ratio buffer provided under the CRR II by one year to January 2023.

This regulatory framework has substantially contributed to the strengthening of the regulations applicable to the banking system in the EU and rendered institutions more resilient to possible future shocks. Although comprehensive, those measures did not address all identified weaknesses affecting institutions. The European Commission has recently adopted a review of the EU Banking Rules relating to the further amendment of the CRR II and CRD V. Having gained important lessons from the COVID-19 pandemic and taking into consideration the necessity of approaching the EU Banking Rules from a greener perspective, the new framework will focus on strengthening the resilience of banking institutions to economic shocks, contributing to the green transition and ensuring sound management of EU banks and better protecting their financial stability.

Rules governing banks' relationships with their customers and other third parties

Regulation relating to customers

Banks' relationships with their customers and third parties deriving from deposit-taking, lending activities and investment services are mainly governed by:

- the law of 30 May 2018 on markets in financial instruments, as amended, transposing, among others, Directive 2014/65/EU of 15 May 2014 on markets in financial instruments (**MiFID II**) and amending Directive 2002/92/EC, Directive 2011/61/EU, and Regulation (EU) 600/2014 of 15 May 2014 on markets in financial instruments (**MiFIR**, together with MiFID II commonly referred to as the **MiFID Framework**), as well as several delegating acts, which provide for harmonised protection of (retail) investors in financial instruments;
- Regulation (EU) 1286/2014 on key information documents for packaged retail and insurance-based investment products (the **PRIIPs Regulation**) applicable since 1 January 2018. The PRIIPs Regulation requires that all packaged retail and insurance-based investment products (**PRIIPs**) manufacturers provide a key information document to retail investors in order to enable retail investors to understand and compare the key features and risks of the PRIIPs;
- the law of 17 April 2018 on key information documents for PRIIPs implementing the PRIIPs Regulation designates the CSSF and the CAA as the competent supervisory authorities regarding supervision and compliance with the requirements of the PRIIPs Regulation; and
- the provisions of the Luxembourg Consumer Code related to the protection of consumers, which also affect banks' dealings with their customers. Following these provisions, banks must, among others, comply with obligations relating to information that should be provided to customers, rules on advertising, the content of credit agreements and the prohibition of unfair business practices. Before granting a credit, the solvency of the customer needs to be evaluated.

Customer complaint handling

In addition, the CSSF is competent to receive customer complaints against the entities subject to its supervision. Provided that, *inter alia*, the customer complaint has been previously dealt with by the relevant professional without a satisfactory result, the customer may request for an out-of-court resolution from the CSSF. The CSSF then acts as an intermediary with the parties in order to seek an amicable solution. The CSSF acts in its capacity as alternative dispute resolution entity, and Luxembourg courts remain competent to handle litigations relating to consumer protection.

Protection of depositors and investors

Following the entry into force of the law of 18 December 2015 on the failure of credit institutions and certain investment firms, the following compensation schemes have been created:

- an Investor Compensation Scheme (*Système d'Indemnisation des Investisseurs Luxembourg*), being the recognised Luxembourg Investor Compensation Scheme as referred to in Directive 97/9/EC and chaired by the CSSF. The main purpose of the Investor Compensation Scheme is to ensure coverage for the claims (funds and financial instruments that its members hold, manage or administer on behalf of their clients) resulting from the incapacity of a credit institution or an investment firm. In case the relevant criteria are met and the institution holding the investor's assets is no longer able to fulfil its commitments, investors are repaid by the Investor Compensation Scheme. The repayment covers a maximum amount of €20,000 per investor; and
- a Deposit Guarantee Fund (*Fonds de Garantie des Dépôts Luxembourg*), being the recognised Luxembourg Deposit Guarantee Scheme referred to in Directive 2014/49/EU of 16 April 2014 on Deposit Guarantee Schemes. The main purpose of the Deposit Guarantee Fund is to ensure compensation of depositors in case of unavailability of their deposits. It collects the contributions due by participating credit institutions, manages the financial means and, in the event of insolvency of a member institution, makes the repayments as instructed by the *Conseil de protection des déposants et des investisseurs*, the internal executive body of the CSSF in charge of managing and administering Luxembourg compensation schemes. It is worth noting that membership to the Deposit Guarantee Fund is compulsory for all credit institutions and Luxembourg branches of credit institutions having their registered office in a third country. In case the relevant criteria are met and the institution holding the depositor's assets is no longer able to fulfil its commitments, depositors are repaid by a Deposit Guarantee Scheme. The repayment covers a maximum amount of €100,000 per person and per bank.

Restrictions on inbound cross-border banking activities

Any person wishing to conduct inbound cross-border banking activities in Luxembourg that fall under the rules of the LFS must obtain the necessary authorisation as stipulated in the LFS. However, credit institutions authorised by a competent authority within the EU/EEA may rely on the European banking passport mechanism. Pursuant to the principle of mutual recognition of authorisation, these authorised institutions are allowed to carry out a number of activities in Luxembourg, subject to having completed the necessary formalities with their home state authorities, which in turn will notify the CSSF.

Substitution of LIBOR

EU Regulation 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the **EU Benchmarks Regulation**) empowers the European Commission to adopt delegated and implementing acts to specify how competent authorities and market participants shall comply with the obligations laid down in the Regulation. Accordingly, on 22 October 2021, the European Commission adopted: (i) Commission Implementing Regulation (EU) 2021/1848 on the designation of a replacement for the benchmark Euro overnight index average that applies as of 1 January 2022; and (ii) Commission Implementing Regulation (EU) 2021/1847 on the designation of a statutory replacement for certain settings of CHF LIBOR that applies as of 3 January 2022. In addition, the working group on euro risk-free rates published a statement titled "Preparedness for the Cessation of EUR, GBP, CHF and JPY LIBORs

and EONIA, and ceasing use of USD LIBOR in new contracts, at the end of 2021" to guide market participants on the adoption of alternative risk-free rates in the absence of an equivalent statutory replacement under the EU Benchmarks Regulation.

The regulatory framework on AML/CFT

Banks must comply with the professional obligations arising from the AML/CFT Law and other applicable regulations, and more specifically customer due diligence obligations, adequate requirements relating to internal management and cooperation requirements with the authorities.

Luxembourg has also strengthened its obligations relating to AML/CFT by transposing certain provisions of the Fourth and Fifth AML Directives, aiming to prevent money laundering and terrorist financing through the implementation of (i) a register aiming to identify ultimate beneficial owners of companies registered with the Luxembourg Trade and Companies Register, which has been effective since 1 March 2019, and (ii) a central register of beneficial owners of fiduciary and similar arrangements, which entered into force on 10 July 2020. These laws require, *inter alia*, that companies registered with the Luxembourg Trade and Companies Register, trustees, and fiduciary agents, obtain and retain data relating to beneficial owners and to certain other persons specified in the respective laws. Registration of certain data collected by the relevant company, trustees and fiduciary agents to the relevant central register is mandatory; failing this, criminal sanctions are provided by these laws.

The AML/CFT Law also enacts the core principle of a "risk-based approach" whereby professionals have to take appropriate measures to identify and assess the risks of AML/CFT with which they are confronted, taking into consideration risk factors such as those related to their customers, countries' geographic areas, products, services, transactions or delivery channels.

The CSSF has the supervisory and investigatory powers to carry out its statutory mission to ensure that all entities subject to its supervision comply with the professional AML/CFT obligations. In addition, the CSSF has broad sanctioning powers. It may, for example, issue warnings or administrative fines against persons subject to its AML/CFT supervision. Monitoring risk in relation to anti-money laundering continues to be a high priority of the CSSF's supervision, and the CSSF staff in charge of the AML/CFT supervision is constantly increasing. Recent changes to the AML/CFT legislation also provide for a stronger cooperation framework between different supervisory authorities both on a national and an international level.

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