ALLEN & OVERY

When governance goes green - Credit institutions need to take into account climate-related and environmental risks

As the management of climate-related and environmental risks is a crucial element to ensure robust internal governance arrangements, the CSSF issued a **CSSF circular 21/773** (the **Circular**) to clarify its expectations towards Luxembourg less significant credit institutions within the meaning of the Single Supervisory Mechanism[1] and branches of non-EU credit institutions.

Climate-related and environmental risks need to be considered and assessed due to their potential impact on a credit institution

Climate change and environmental degradation can translate into physical and/or transition risks and therefore impact the financial situation or operational capacity of credit institutions.

Physical risk refers to the financial impact of a changing climate and environmental degradation. Transition risk refers to the financial loss that may be triggered for a credit institution when adjusting towards a lower-carbon and more environmentally sustainable economy. These two risk drivers may have an impact in terms of credit risk, operational risk, market risk, liquidity risk, reputational risk etc.

The CSSF stresses that while the proportionality principle may apply, the size of a credit institution does not automatically determine the materiality of the risks to which it is exposed.

[1] Significant credit institutions under the direct supervision of the ECB shall refer to the ECB Guide on climate-related and environmental risks

A series of governance arrangements need to be reviewed to take into account climate-related and environmental risks

In order to comply with the obligation to have robust governance arrangements[2], credit institutions must:

- Regularly assess and document the materiality and the relevance of their exposure to climate-related and environmental risks and, on that basis, define and regularly review their business strategy and risk appetite;
- Integrate material risks into their risk management framework (including the stress testing component). The Circular provides examples of how physical and transition risk drivers may lead to increased risks;
- Review and amend the internal organisation arrangements for the three lines of defence;
- Develop regular and transparent reporting to the management body;
- Develop specific training programs for their staff; and
- In case climate-related and environmental objectives have been defined, review their remuneration policy and consider providing for a variable remuneration component linked to the completion of these objectives.

The management body shall have overall responsibility for due consideration of climate-related and environmental risks in the governance arrangements of the credit institution.

Credit institutions shall immediately start the review of their governance arrangements

While the Circular is applicable with immediate effect, the CSSF expects credit institutions to start reviewing all relevant governance arrangements by mid-year 2021 in order to progressively incorporate climate-related and environmental risks.

[2] Article 5 of the Luxembourg act of 5 April 1993 on the financial sector, as amended.

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