Commission de Surveillance
du Secteur Financier

ESMA Common Supervisory Action on UCITS Liquidity Risk Management

CSSF FEEDBACK REPORT

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1. Context

On 30 January 2020, the European Securities and Markets Authority ("ESMA") launched a Common Supervisory Action ("CSA") with national competent authorities ("NCAs") across the EU/EEA on the supervision of UCITS managers' liquidity risk management ("LRM").

The UCITS framework includes a broad range of regulatory provisions aimed at ensuring that all relevant risks, including liquidity risks, are identified, measured, monitored and effectively managed in order to ensure that UCITS investors can redeem their investments upon request. Compliance with the UCITS LRM rules is key to ensure financial stability, investor protection and the orderly functioning of financial markets.

To this aim, ESMA launched the CSA with a view to assessing whether market participants adhere to those rules in practice. This was done on the basis of a common methodology developed at the level of ESMA.

The CSA was a two-stage process where:

- in a first stage, NCAs requested quantitative data from a large majority of UCITS managers based in their respective Member States to get an overview of the supervisory risks faced; and
- in a second stage, NCAs focused on a sample of UCITS managers and UCITS to carry out more in-depth supervisory analyses.

The CSSF launched the first stage of the CSA in February 2020 by asking 155 Luxembourg-based UCITS investment fund managers ("IFM"), representing 80% of the total number of such IFM, to complete a dedicated questionnaire for all UCITS they manage.

Then, based on the answers received, the CSSF selected 51 IFM (representing more than 25% of the total number of such IFM) and launched the second stage of the CSA in July 2020. In this second stage, each IFM was required to complete a second questionnaire, with documentary evidence to be provided for each corresponding answer, and to provide the CSSF with line-by-line portfolio and liquidity data for a selection of UCITS.

At the end of December 2020, the CSSF sent its final report on the CSA exercise to ESMA.

On 24 March 2021, ESMA published the results of the CSA in a Public Statement, including the experiences and findings of all 30 EU/EEA NCAs (including the CSSF) participating to the exercise. ESMA informed in that context that the overall level of compliance with the applicable rules on LRM was satisfactory for most UCITS managers, but that the exercise also showed shortcomings in some areas and the need for improvements in certain key areas. ESMA also mentioned that further work will be performed for promoting supervisory convergence and that it will consider whether the results of the CSA should lead to any follow-up policy work.

While the overall analysis of compliance for IFM in Luxembourg is consistent with the conclusions of ESMA, the objective of the present feedback report is to inform the industry about the main observations that the CSSF made in the context of its CSA supervisory work as well as about the related recommendations for improvements in view of the applicable regulatory requirements.

Those results are to be read in conjunction with the above mentioned ESMA Public Statement, as well as the ESMA report 'Recommendation of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds' (ESMA34-39-1119) published on 12 November 2020 that sets out ESMA's analysis and conclusions on the preparedness of investment funds with significant exposures to corporate debt and real estate assets to potential future adverse shocks and presents five priority areas identified to enhance the preparedness of these funds.

The CSSF is currently engaging on a bilateral basis with IFM in relation to the observations made in the context of the CSA exercise, thereby asking these IFM to implement the necessary corrective measures for the shortcomings observed.

In addition, the CSSF asks hereby all IFM to conduct, by the end of 2021, a comprehensive assessment with regard to the compliance of their LRM set-ups in relation to the observations of ESMA and of the CSSF and to take, if applicable, the necessary corrective measures.

In this context the CSSF also reminds IFM of the IOSCO recommendations and good practices on liquidity risk management for undertakings for collective investment as implemented in national regulation by means of CSSF Circular 19/733 ("IOSCO Recommendations").

2. Observations

2.1 Pre-investment forecasts and analyses of liquidity

Article 26(4) of CSSF Regulation 10-4 requires from IFM when implementing their risk management policy, and **where it is appropriate after taking into account the nature of a foreseen investment**, to **formulate forecasts and perform analyses** concerning the investment's contribution to the UCITS' portfolio composition, liquidity and risk and reward profile **before carrying out the investment**. These analyses must only be carried out on the basis of reliable and up-to-date information, both in quantitative and qualitative terms.

Article 2(1) of the Grand-Ducal Regulation of 8 February 2008 ("GDR") as regards the clarification of certain definitions lays down that, **unless there is**

information available to the UCITS that would lead to a different determination, financial instruments **admitted** or **dealt in on a regulated market** shall be presumed **not** to **compromise the ability** of the UCITS to **redeem** its units **at the request** of any investor and shall also be presumed to be negotiable.

The CSSF observed in the context of its CSA work that IFM in general (i) assess / analyse the liquidity of potential investments and their contribution to the overall liquidity profile of the relevant UCITS and (ii) ensure notably in the investment phase that there are sufficiently liquid assets in the portfolio so as to be able to meet future redemption requests.

However, the CSA exercise also showed that these liquidity assessments were often not backed by a formalized and well-defined framework setting out the responsibilities, arrangements and associated procedures concerning pre-investment liquidity assessments. Further, the liquidity assessments performed by the IFM before making investments were often not subject to an adequate formalization. In addition, IFM did generally not carry out liquidity forecasts at the pre-investment phase, including for less liquid assets and assets not admitted or dealt in on a regulated market. Finally, some IFM did rely on the presumption of liquidity in view of the nature of financial instruments authorized by the investment policy of the UCITS without performing checks for ensuring the ongoing adequacy of that presumption.

On that basis, the CSSF expects IFM, in accordance with the applicable regulation, to define and implement a formalised and risk-based pre-investment liquidity assessment framework, which shall be part of the risk management policy of the IFM and which shall provide, at a minimum, for the following elements:

- a clear allocation of responsibilities at the level of the IFM for the assessment of liquidity at pre-investment level, thereby taking into consideration the set-up of the portfolio management process;
- a documented and well-founded approach towards the presumption of liquidity of Article 2(1) of the GDR, together with the arrangements in place to review on a periodic basis the accuracy of that approach on the basis of reliable and up-to-date data;
- the carrying out of adequate and documented liquidity analyses and forecasts at pre-investment level for less liquid assets and assets not admitted or dealt in on a regulated market (so-called “trash ratio” investments).

2.2 Ongoing alignment of redemption policies and liquidity profiles

Article 45(3) of CSSF Regulation 10-4 requires from IFM to employ an appropriate liquidity risk management process in order to ensure that each

UCITS they manage is able to redeem its units at the request of any investor. Article 45(4) of CSSF Regulation 10-4 further requires that IFM ensure that, for each UCITS they manage, the liquidity profile of the investments of the UCITS is appropriate to the redemption policy laid down in the management regulations or the instruments of incorporation or the prospectus.

Coverage of the redemption risk

The CSSF noted that some IFM did not have adequate approaches / methodologies in place to forecast potential investor redemption requests as they were based, for instance, on static / default parameters which did not sufficiently take into account the structure, composition and potential concentration of the investor basis. This was sometimes also due to the fact that these IFM did not possess adequate information on the characteristics of the distribution channels and, as a result, of the underlying investor basis.

In this context, the CSSF reminds the following provisions of Circular CSSF 19/733 that request, amongst others, from the IFM:

- to seek to engage with constituent elements of the distribution chain to take reasonable steps to improve their understanding of the underlying type of investors and the behavioural characteristics associated with such relevant types of investors (IOSCO Recommendation 4);

- to consider liquidity aspects related to its proposed distribution channels, including to take all reasonable steps to obtain investor concentration information from nominees to assist its liquidity management (IOSCO Recommendation 5).

On that basis, the CSSF asks IFM to implement the necessary approaches allowing them to have an adequate understanding of the investor base of the UCITS as this constitutes an important building block of a comprehensive LRM process.

Coverage of liabilities other than redemptions

The CSSF noted that liabilities other than redemptions (e.g. margin calls from the usage of financial derivative instruments) are for some IFM covered by control processes that are not part of the LRM processes and that are thus not integrated in the ongoing liquidity assessments of the IFM. IFM consider, for instance, potential payment obligations arising from the use of financial derivative instruments in the context of the monitoring and control of the cover rules of box 28 ("Cover rules for transactions in Financial Derivative Instruments") of the CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS.

Given the importance of a comprehensive and integrated coverage of liquidity risks to which UCITS are or may be exposed, the CSSF requires IFM to integrate all liability risks that may have a material impact on the liquidity profile of the fund in their LRM processes and related methodologies.

Interaction between liquidity and valuation risks

The CSSF also asks IFM to enhance, where appropriate, LRM processes in relation to the interlinkages that may exist between the liquidity risk and the valuation risk. More particularly, the CSSF expects IFM to take into account the experiences from their valuation processes in their ongoing liquidity assessments and to adjust, if necessary, the liquidity assessment for assets that present a higher valuation risk (e.g. in case of stale prices or suspended assets).

Other observation

As the CSSF noted that possible contagion risks (e.g. redemptions occurring in different funds managed by the IFM which invest in similar investment strategies) are generally not considered by IFM in their LRM processes, the CSSF asks IFM to give consideration, where appropriate, to such risks in their LRM set-up.

2.3 Liquidity risk measurement and data reliability

Article 45(2)(a) of the CSSF Regulation 10-4 requires from IFM to put in place for each UCITS they manage such **risk measurement arrangements, processes and techniques** as are necessary to ensure that the **risks** of taken positions and their contribution to the overall risk profile are **accurately measured** on the basis of **sound and reliable data** and that the risk measurement arrangements, processes and techniques are adequately documented.

Adequacy of liquidity risk measurement methodologies / models

The CSA exercise showed that some LRM methodologies / models used by IFM did not provide for a comprehensive coverage of all assets held by the UCITS as such methodologies did not allow to determine the asset liquidity risk for some specific assets (e.g. securitization positions).

The CSSF reminds in this context that IFM shall, before making investments in specific asset classes and assets, ensure that these can be handled in an adequate manner by their LRM processes and related liquidity risk measurement methodologies / models. If specific individual positions might not be covered by the methodology / model, IFM shall revert to alternative liquidity assessments that provide for adequate results.

In addition, the IFM shall perform an ongoing and documented review concerning the adequacy of their liquidity risk measurement methodologies / models and data used.

Data reliability controls

The CSSF noted that some IFM could not provide evidence of the existence of documented controls concerning the soundness and reliability of the data used in their LRM processes. These UCITS managers did (over)rely on the data collected from third party vendors without performing any additional checks.

On that basis, the CSSF asks IFM to ensure that adequate controls are in place in order to verify the reliability of the data used for the ongoing liquidity assessments. The data used shall also reflect the prevailing market conditions.

With regard to the issues on the adequacy of liquidity risk measurement methodologies / models and data reliability controls, the CSSF stresses that fully adequate liquidity risk measurement methodologies, using reliable and up-to-date data, are key in LRM processes as they are a prerequisite for reporting adequate liquidity information to the Senior Management and Board of Directors and for allowing these bodies to take, on a fully informed basis, the necessary decisions.

2.4 Governance and control mechanisms

Liquidity Risk Management policy

Article 43(1) of CSSF Regulation 10-4 requires from IFM to establish, implement and maintain an adequate and documented **risk management policy** which identifies the risks which the UCITS they manage are or might be exposed to. The risk management policy shall comprise such procedures as are necessary to enable the management company to assess for each UCITS it manages the exposure of that UCITS to market, **liquidity** and counterparty risks, and the exposure of the UCITS to all other risks, including operational risks, which may be material for the UCITS it manages.

In a few cases the CSSF observed that no adequate LRM policy was in place for IFM taking due account of the nature, scale and complexity of their business and of the UCITS they manage. The CSSF stresses that each IFM shall have a comprehensive risk management policy which is fully adapted to its organizational set-up in Luxembourg.

Such risk management policy shall be separate from the risk management procedure document to be submitted annually to the CSSF, as explained in sub-sections 5.3.1.4 and 5.3.1.5 of CSSF Circular 18/698 and especially point

220 which sets out that "[...] *whereas the risk management procedure [...] is a synthetic communication tool vis-à-vis the CSSF allowing it, in particular, to carry out its prudential supervision with respect to risk management, the risk management policy is a documentation which is more free in form but more detailed in content and which includes, among others, processes, techniques, tools and allocations of responsibilities for the performance of risk management.*"

Assessment of the fund's liquidity risks during the product design phase

Article 13(3)(e) of CSSF Regulation 10-4 requires from the permanent risk management function of an IFM to provide advice to the Board of Directors as regards the identification of the risk profile of each managed UCITS.

In some cases, the CSSF noted room for improvement of the liquidity risk assessments during the product design phase (including also in the context of the new product committee) concerning the formalisation of the decision process and the contents of the risk analyses performed.

More particularly, the CSSF observed cases where IFM were unable to provide adequate documentation on the assessment of liquidity risks made in the context of the product design phase.

The CSSF requires, in accordance with IOSCO Recommendation 4 , that IFM conduct during the design phase process a documented assessment of the liquidity risks that the UCITS is likely to face, having regard, amongst others, to its proposed investment strategy as well as assets and instruments to be invested in.

Reporting and monitoring of the liquidity risks to the Senior Management and the Board of Directors

Article 13(3)(e) of the CSSF Regulation 10-4 requires the permanent risk management function of the IFM to provide:

- regular reports to the Senior Management outlining the current level of risk incurred by each managed UCITS and any actual or foreseeable breaches of their limits, so as to ensure that prompt and appropriate action can be taken;
- regular reports to the Board of Directors, amongst others, on the consistency between the current levels of risk incurred by each managed UCITS and the risk profile agreed for that UCITS and the compliance of each managed UCITS with relevant risk limit systems.

In a few cases, the CSSF observed that the regular liquidity risk reporting provided to the Senior Management and Board of Directors of the IFM was not sufficiently detailed for meeting the applicable requirements.

The CSSF reminds IFM that risk management information to be provided on a regular basis to the Senior Management and Board of Directors, in accordance with the above-mentioned requirements, shall provide for sufficiently clear, accurate and detailed information on the liquidity risks incurred by each managed UCITS to allow them to take, on a fully informed basis, the appropriate decisions.

Escalation processes

The CSA exercise showed for some IFM that the escalation processes concerning liquidity risks were based on inappropriate limits/triggers, or that the escalation processes were not supported by adequate documentation concerning the related decision-making process and follow-up actions.

The escalation processes to the Board of Directors of the IFM also showed sometimes a lack of reactivity for supporting timely actions / decisions, while article 45(2)(f) of CSSF Regulation 10-4 states that IFM shall establish, implement and maintain adequate procedures that, in the event of actual or anticipated breaches to the risk limit system of the UCITS, result in timely remedial actions in the best interests of investors.

The CSSF also observed that only a few IFM were able to provide concrete examples of escalations to Senior Management / Board of Directors during the Covid-19 crisis, whereas one might have expected that, given the market circumstances with elevated redemptions, lower liquidity in some market segments and larger use of liquidity management tools, there would have been ad hoc or trigger-based escalations to Senior Management / Board of Directors.

Permanent compliance and internal audit functions

In the CSA exercise the CSSF identified shortcomings in the set-up of the LRM processes of IFM, as evidenced by the list of observations set out in the present document, which were previously not detected by the compliance or internal audit functions in their monitoring / review activities. In addition, the exercise showed that the permanent compliance and internal audit functions of only a limited number of IFM recently performed specific reviews with regard to the LRM processes.

On that basis, the CSSF requires IFM, in accordance with Article 11(1) and (2) of the CSSF Regulation 10-4 and Article 12(2) of the CSSF Regulation 10-4, to provide for an adequate and regular involvement of the compliance and internal audit functions in the review of the adequacy of LRM processes.

2.5 Information to the investors in the KIID

According to Article 8(1)(b) of the Commission Regulation (EU) 583/2010, the 'Risk and Reward Profile' of the KIID shall contain a synthetic indicator, supplemented amongst others by a narrative explanation of risks which are materially relevant to the UCITS and which are not adequately captured by the SRRI indicator.

Paragraph 5(b) of the same Article requires that the narrative explanation includes in particular, where it is material, "*liquidity risk, where a significant level of investment is made in financial instruments, which are by their nature sufficiently liquid, yet which may under certain circumstances have a relatively low level of liquidity, so as to have an impact on the level of liquidity risk of the UCITS as a whole*".

The CSSF observed that in some cases the disclosure in the KIID in relation to liquidity risks shall be enhanced as, for instance, the liquidity risks attached to some financial instruments held by UCITS were not set out in an adequate manner in the KIID.

The CSSF expects IFM to define and implement a documented internal approach underlying the definition of what is material or not in terms of liquidity risks for supporting the disclosure in the KIID.

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