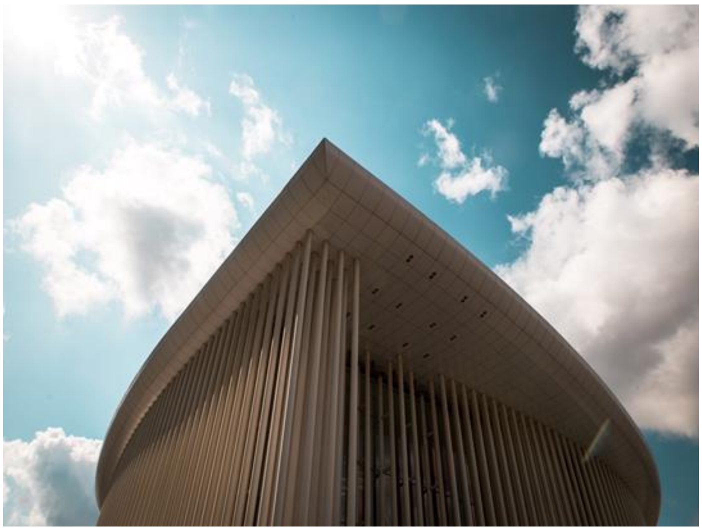
Liquidity Risk Management process for Collective Investment Schemes

CSSF Circular 19/733

On 20 December 2019, the Commission de Surveillance du Secteur Financier (CSSF) published Circular 19/733 on liquidity risk management for open-ended undertakings for collective investment. The Circular aims at implementing the recommendations and good practices of the International Organization of Securities Commissions ("IOSCO") on liquidity risk management for undertakings for collective investment. More specifically, the recommendations seek to ensure that liquidity is appropriately managed to protect the interests of investors.

The Circular enters into force with immediate effect and applies to:

- Management companies (under chapter 15 and chapter 16 of the Law of 17 December 2010 relating to UCI's).
- Luxembourg branches of Investment fund managers (under chapter 17 of the 2010 Law).
- Self-managed SICAVs under article 27 of the 2010 Law.
- Authorized AIFMs (under chapter 2 of the Law of 12 July 2013 (the "2013 Law").
- Self-managed alternative investment fund managers (under point (b) of Article 4(1) of the Law of 12 July 2013).
- Self managed undertakings for collective investments (under Part II of the Law of 17 December 2010).



The IOSCO Recommendations cover the following elements of the liquidity risk management process:

The design process of UCIs:

The liquidity risk management process should be supported by a strong governance that is effective both in normal and stressed market conditions. UCI's redemption policy should appropriately reflect the investment strategy and the underlying assets. Moreover, the integration of obligations of UCI's, other than investor redemption should be considered. Moreover, Liquidity management tools (LMT) should be integrated to ensure sound liquidity management under exceptional market conditions. Also, UCI's should consider the way the planned marketing and distribution are likely to impact the liquidity of UCI's and implement tools to disclose the liquidity risk to investors.

The day-to-day liquidity management of UCIs:

The liquidity of the UCI should be regularly measured, monitored and managed. Stress testing arrangements should be appropriate with regards to the size, investment strategy, underlying assets and investor profile (redemption policy or other liabilities) of the UCIs, while considering other factors (example : market and reputational risks), where relevant. Scenarios should include backward-looking historical scenarios and forward-looking hypothetical scenarios. The regularly updated liquidity risk management should facilitate the identification of emerging liquidity pressures/shortages before they occur and should integrate relevant data and factors in order to have a holistic view of the possible risks.

Contingency planning:

Contingency plans should be implemented and periodically tested to ensure that any applicable LMTs can be used where necessary. The IOSCO recommendations indicate a list of the LMTs which are available to Luxembourg domiciled UCIs.

Brexit

Consequences for the distribution of funds and insurance products

On 31 January 2020, the United Kingdom's formally exited from the European Union in accordance with the Withdrawal Agreement and Article 50(3) of the Treaty on European Union. For UK and EU firms nothing will change in 2020, but what happens from January 2021 onwards remains an open question as the future relationship between the EU and UK is still undefined. The article analyzes the impacts for the distribution of funds and insurance products on both territories.

<u>Transition period and beyond:</u>

The Withdrawal Agreement provides for a transition period between the UK and the EU during which EU law will continue to be applicable to and in the UK until 31 December 2020. After 2020, the following three scenarios remain on the table:

1. Under a joint agreement between the EU and the UK before 1 July 2020, the transition period is extended by a year or two.
2. A trade agreement governing arrangements is reached between the EU and the UK. The agreement will need to be formally approved by and effective on 1 January 2021.
3. Neither the transition period is extended, or an agreement is reached, leaving both the UK and the EU exposed to the effect of a so-called Hard Brexit.

<u>Theoretical Implications for the distribution of UCITS and AIF's in a worse case scenario/ Hard Brexit:</u>

UK UCITS will no longer be UCITS under EU regulation defined as funds domiciled in the EU with EU-established management companies. Moreover, UK management companies will neither be able to distribute UCITS in the UK or the EU.

On the other hand, AIFs and AIFMs may be established inside or outside the EU. Hence, on paper, there is nothing that prevents EU AIFs from being sold into the UK, or EU AIFMs to manage UK AIFs (and vice versa).

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Mitigation mechanisms in case of a hard Brexit:

The UK Government, under Boris Johnson, is not keen on letting the transition period last longer than is currently foreseen. Therefore, Passporting rights will cease and EEA firms currently operating in the UK through the existing European passport framework will require a Part 4A permission under the Financial Services and Markets Act (FSMA) to be able to continue carrying out regulated activities in the UK.

However, UK regulators have come up with various contingency plans to persuade European fund managers and insurance companies not to exit completely from the UK.

In February 2019, the European Securities and Markets Authority (ESMA) and European securities regulators agreed a memoranda of understanding (MoU) with the UK's Financial Conduct Authority in the event of a no-deal Brexit. Under the MoU fund manager will be allowed to outsource and to delegate activities to UK-based entities on behalf of counterparties based in the EEA.

In order to continue marketing EU domiciled funds or insurance products in the UK, the regulator has put forward Temporary Permissions Regime (TPR). The TPR allows firms to carry out business in the UK after the passporting regime ends for a period up to three years.

Concerned investors and the need for relocation:

Although the previously mentioned contingency plans put forward offer some cushion to fund managers and insurance companies. EU-based investors have become increasingly hesitant about buying into funds or insurance products managed in the UK. In fact, billions of euros of EU investor assets have already been transferred from the UK to other territories to alleviate investor concerns. The race for attracting investment managers and insurance companies has started and includes Dublin, Luxembourg, Frankfurt, Paris and Amsterdam.

Luxembourg as a potential market for relocation:

In the race for attracting investment managers and insurance companies, Luxembourg is considered an attractive candidate compared to its peers based on the following criteria's

- Geographical position in the EEA.
- Availability of a skilled and international workforce.
- Regulation stability.