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CSSF: ESMA Guidelines on Liquidity Stress Testing in UCITS and AIFs

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In the midst of the COVID-19 crisis, liquidity risk management is certainly a topical question, as it is meant to prepare a fund for a crisis so that it may meet redemption requests in normal and stressed conditions.

Circular 20/752

The Luxembourg Financial Sector Supervisory Authority (CSSF) issued a new circular on 29 September 2020 (Circular) to integrate the guidelines of the European Securities and Markets Authority (ESMA) on liquidity stress testing (Guidelines), (initially published a year before in September 2019), into the administrative practice and regulatory approach of the CSSF.

In respect of funds, the Guidelines are relevant to all undertakings for collective investment in transferable securities (UCITS) and alternative investment funds (AIFs) including exchange traded funds, with the exception of unleveraged closed-ended AIFs. Provisions also apply to depositaries and national competent authorities (NCAs).

The purpose of the Guidelines is to enhance the standards, consistency and frequency to be followed by investment fund managers (IFMs) for liquidity stress testing (LST) for UCITS and AIFs and to promote supervisory convergence by national competent authorities in the European Union.

LST is defined in the Guidelines as a risk management tool within the overall liquidity risk management framework of an IFM, which simulates a range of conditions, including normal and stressed (ie extreme, unlikely or unfavourable) plausible conditions, to assess their potential impact on the funding (liability), assets, overall liquidity of a fund and the necessary follow-up action.

The Guidelines include three sections that relate respectively to IFMs, depositaries and the interaction of IFMs with NCAs. It sets out 16 guidelines applicable to IFMs in different areas. In a nutshell, in accordance with the Guidelines, IFMs are required *inter alia*, to:

- have a strong understanding of the liquidity risks arising from the assets and liabilities of the funds they manage
- regularly conduct stress tests, at least annually, under normal and exceptional liquidity conditions, to assess and monitor the liquidity risk to which their funds are exposed, taking into account the specific fund's characteristics in question
- draft, regularly review, and update as the case may be, a LST policy, which covers *inter alia* the governance, types, frequency and severity of stress test scenarios, the reporting process and an escalation procedure (said LST policy should be integrated in the overall risk management policy)

Furthermore, the Guidelines set forth that IFMs should notify the CSSF of material risks and actions taken to address them.

In respect of depositaries, the CSSF clarified that they are not required to assess the adequacy of the LST undertaken by an IFM. Depositaries of UCITS and AIFs should nevertheless set up appropriate verification procedures to check that the IFM has in place documented procedures for its LST programme. In case the depositary is not satisfied that LST is in place, it should take action accordingly and in line with usual actions in case of any other evidence of a potential breach of rules by an IFM.

Conclusion

IFMs must ensure they are able to comply in full with the Guidelines as both the Circular and the Guidelines entered into force on 30 September 2020. Accordingly, IFMs should take this opportunity to review their liquidity management processes and identify any changes to liquidity stress testing procedures that should be implemented and additionally, if not already in place, prepare a documented liquidity stress testing policy.

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