



Association of the Luxembourg Fund Industry
Association Luxembourgeoise des Fonds d'Investissement

Q&A

CSSF Circular 11/512

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Important

This document was prepared by ALFI's Risk Management Technical Committee. The working group comprises representatives of asset managers, management companies, securities service firms, audit firms, law firms, and document and information management firms.

This document contains the working group's answers to questions about the implementation and the application of the CSSF Circular 11/512. The answers are not necessarily definitive and they might not be suitable for every circumstance. **This document is not meant to be an industry standard or a guide to best practice** but it represents the view from a group of market participants. The Q&A has not been validated by any regulator. It does not diminish the management company's or the investment company's responsibility to comply with the CSSF Regulation 10-4 and the CSSF Circular 11/512 or CESR's related guidelines and any other European or national law or regulation. This document must not be relied upon as advice and is provided without any warranty of any kind and neither ALFI nor its members who contributed to this document accept any liability whatsoever for any action taken in reliance upon it.

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ALFI's members are welcome to submit a question to the working group, which will review it and consider whether to include it in a future copy of this document. Please send your questions to info@alfi.lu. We will acknowledge receipt of each question but we regret that we may be unable to reply individually to each one.

Questions	Proposed Answers
I. Questions related to Risk Disclosures/Transparency	
<p>1. If a UCITS has a year ending on 30/9, is the leverage disclosure in the annual report already necessary for the financial year 2011?</p>	<p>The risk transparency disclosures in the annual reports of UCITS are mandatory as of the financial year ending December 31, 2011 (please see paragraph 2 Section IV.6 CSSF Circular 11/512), these include:</p> <ul style="list-style-type: none"> - The method used to calculate the global exposure (commitment approach or relative / absolute VaR); - Detailed information for the VaR method (incl. type of model, leverage level). <p>For all UCITS with a financial year-end prior to December 31, 2011 the risk transparency disclosures are optional, i.e. they can be included.</p>
<p>2. In case a new (Sub-)Fund is launched, how can the leverage figure which has to be disclosed in the prospectus be estimated? When should the estimated leverage figure be reviewed / updated in the prospectus?</p>	<p>CESR/10-788 (Boxes 2 and 9) and CSSF Circular 11/512 (IV.5.2. Assessment and disclosure of the expected level of leverage) do not formally address how to estimate accurately the level of leverage for a new UCITS. In order to have an adequate information basis to estimate the leverage, practitioners may consider the following steps:</p> <ul style="list-style-type: none"> - Discussing the future portfolio composition with the respective investment advisor or manager; - Analyse a model portfolio (if available). <p>Based on the information gathered, the estimation of the leverage for a new UCITS shall be conducted by the</p>

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	<p>Management Company (>>ManCo<<) on an arm's length basis, involving all relevant stakeholders (such as, e.g., Risk Management, Portfolio Management, Product development function, Conducting Officers).</p> <p>Practitioners should consider reviewing the estimated level of leverage regularly by confirming the estimated leverage figure to the actual leverage figures. A possible frequency may be on an annual basis (e.g., at the first and following financial year-ends of the (new) UCITS), if no material changes occur during the year.</p> <p>The ManCo or Board of Directors of a SICAV may decide on review procedures (e.g. warning levels) which would trigger an update of the expected leverage levels as disclosed in the prospectus. We would suggest that these procedures are applied consistently across the ManCo's or SICAV's UCITS.</p>
<p>3. What is the leverage to be disclosed, i.e. full portfolio or only derivatives? How should the leverage be disclosed, as an absolute or percentage figure?</p>	<p>In view of ESMA Guidelines 10-788 (Boxes 2 and 9), the CSSF has specified that the leverage calculation for a UCITS is for derivatives and related transactions only (please see Section IV.5.2 CSSF Circular 11/512) by taking into account:</p> <ul style="list-style-type: none"> ▪ Financial derivative instruments concluded; ▪ Reinvestment of collateral received (cash) in connection with efficient portfolio management transactions (if reinvestment is not assets providing risk-free return); ▪ Collateral received by the UCITS and re-used within any other efficient portfolio management transaction (e.g. securities lending).

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	<p>It follows that if none of the above are used in an UCITS the leverage level is zero.</p> <p>Practitioners may consider providing further information to investors as to whether the investment portfolio (i.e., non-derivatives portfolio) is included in the leverage figure or not.</p> <p>Concerning the disclosure of leverage levels, both a percentage (150%) or an absolute (e.g. 1.5 times NAV) figure of NAV are permissible. We would recommend the ManCo or Board of Directors of a SICAV to consistently apply the leverage figure disclosure type across its UCITS range.</p>
<p>4. Which data should be used for the leverage calculation for the annual report disclosure?</p>	<p>Guidance has been given as to the data points to be considered for the leverage calculation in CSSF Circular 11/512 (please see paragraph 6 Section IV.6); the minimum required data points are two a month (i.e. 24 a year).</p> <p>We would suggest that the ManCo or Board of Directors of a SICAV use consistent data points across their UCITS range.</p>
<p>5. Should the disclosure of leverage also include information on the computation method (notional/commitment) used?</p>	<p>Yes, paragraph 4 Section IV.5.2 CSSF Circular 11/512 requires that the leverage calculation method shall be disclosed, i.e. either the sum of notionals or commitment approach.</p> <p>Practitioners may choose to add a clarification on how this leverage figure has been calculated. In addition on may give</p>

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	<p>further explanations about the use of derivatives as part of the investment strategy/objective of a fund. The disclosure may also include important elements to put the leverage figure into context, such as share class hedging and the types of derivative instruments used as well as the collateral coverage of these.</p>
<p>6. What is the level of documentation required in section 1.6 and 1.7 of the Appendix in CSSF Circular 11/512, i.e. copies of each information report at the date of financial year-end of the management company?</p>	<p>CSSF Circular 11/512 prescribes in section III.1.1 that the Risk Management function shall regularly report to the Conducting Officers / Board of Directors (and the supervisory function (if applicable) on the adequacy and effectiveness of the RMP.</p> <p>It is our understanding that, for the purpose of section 1.6 of the appendix of Circular 11/512, practitioners shall provide CSSF with an example on the reporting of the assessment of:</p> <ul style="list-style-type: none"> • the adequacy, i.e. is the risk management process covering all material risks based on the current product and financial instruments scope (e.g. risk limits, model coverage, etc); • the effectiveness, i.e. proper performance of risk measurement as well as detection and escalation of limit breaches and outliers to the management and the BoD. <p>CSSF Circular 11/512 prescribes in section 1.7 of the Appendix that regular reports made by the risk management function of the ManCo are to be communicated to the CSSF at least annually.</p>

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	<p>Due to the differences in scope, structure and frequency of the regular reports made by the various ManCos, the level of documentation may vary. It is our understanding that the ManCo shall provide CSSF with examples of report(s) proving that a holistic risk reporting is provided to Senior Management/ Board of Directors.</p>
<p>II. Questions related to Portfolio Risk Calculation methods:</p>	
<p>7. Does the maximum potential loss approach mentioned in CSSF Circular 11/512 in IV.4.1 (concentration risk) be interpreted in applying a Value-at-Risk figure?</p>	<p>Paragraph IV.4.1. refers to the situation where, for a specific FDI, the conversion of the FDI into the equivalent position in the underlying asset (i.e., commitment approach) proves to be inadequate. In this case, the maximum potential loss linked to the FDI shall be used as its exposure for concentration risk in the event of default by the issuer.</p> <p>It is our understanding that the VaR contribution of an individual FDI cannot be deemed to reflect the maximum potential loss of that FDI.</p>
<p>8. What risk categories should be included in the stress testing?</p>	<p>As part of a general requirement on risk measurement a ManCo shall – where appropriate - conduct stress tests and scenario analyses to address risks arising from potential changes in market conditions that might have an adverse impact upon the managed UCITS.</p>

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	<p>This means in principle all risk categories relevant for a UCITS need to be considered in stress testing.</p> <p>UCITS that use the VaR approach (for market risk) must conduct stress tests. In addition, the Circular makes reference to stress tests for the modeling of the net subscription and redemption flows with regards to the liquidity risk.</p> <p>As such, the stress testing could therefore focus both on the market risk and the liquidity risk. The stress scenarios to be foreseen would cover the market movements impacting asset value and liquidity of positions. The combination with the stress testing of subscription and redemption flows provides a rounded-up and consistent in terms of impact.</p> <p>Nevertheless, the proportionality principle as set out under the Circular does allow the UCITS to adapt its stress testing procedures to the nature, size and complexity of the investment strategies and or investor base. Also, the materiality of the risks as determined in the 'risk profile' of the UCITS will be important to determine the scope of the stress testing to be performed.</p> <p>The following criteria are likely to impact both the market and liquidity stress tests:</p> <ul style="list-style-type: none">• Market price sensitivity per asset (class)• Market size/trading volume• Type of asset• Fair value pricing

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	For further details, we refer to the CSSF circular 11/512 III.
9. What is the use of the stress test results?	<p>The primary objective of stress test is to inform the management and the Board on plausible downside risk scenarios as well as to allow a plausibility check on the results of the VaR computation. If stress test results provide any material issues, the risk management function will also discuss those results with the relevant portfolio manager.</p> <p>The use of the stress test depends on the recipient:</p> <ul style="list-style-type: none"> • Board: assessment of downside risk and decision making on investment strategy adjustments for liquidity or market risk issues; • Senior Management: periodic/ongoing review and assessment of adequacy of ST concept – in particular on liquidity and market originated tail risks and decide on necessary measures, report to Board on ST and necessary measures (if needed); • Risk Management function: periodic/ongoing monitoring of liquidity and market originated tail risks in order to (i) prepare and suggest Board actions and (ii) plausibility check on the VaR model results. <p>The stress test results are to be addressed with the portfolio managers in the light of corrective measures to avoid over- or under-exposure (i.e. –performance). Such discussions can be led by the risk management function and the outcome is to be documented and part of the senior management and BoD</p>

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	reporting.
<p>10. For the case one applies a commitment approach based on a duration netting in line with CSSF 11/512 requirements one also needs to consider 'remaining FDIs' not being included in the duration netting. How shall this be done?</p>	<p>The positions remaining open after the full duration netting approach are to be included as duration weighted positions in the normal commitment approach. The final commitment is the sum of the duration netted position plus the other FDIs calculated based on the commitment calculation method described in the circular 11/512.</p>
<p>III. Questions related to reporting and delegation</p>	
<p>11. How can the reporting to the conducting officers vs. the reporting to the BoD look like?</p>	<p>Adequate risk reporting is key for a risk function and in particular for the Senior Management (i.e., Conducting Officers) of a ManCo to ensure they can comply with their obligations and responsibilities of oversight.</p> <p>The extent and frequency of the reporting to Conducting Officers and the Board may vary depending on the structure of the RM function (e.g. is a separate Risk Department established) and the governance structures established within the ManCo itself (e.g. roles of BoD, CO, internal departments).</p> <p><u>Best practice proposals on reporting to Conducting Officers and the Board:</u></p> <p><u>Ad-hoc reporting</u> (CO) should be involved in the on-going oversight of the Risk Management process and should act as the point of escalation for any breaches of risk limits (i.e. ad-hoc reporting).</p>

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	<p>Clear escalation routes shall be used to escalate material RM issues first to conducting officers and, ultimately, to the Board.</p> <p><u>Regular reporting</u></p> <p>1. <u>Conducting Officers risk report</u> In order to ensure that the CO (respectively a risk function) obtains the necessary information from the departments in the ManCo as well as from outsourcing partners, a structured bottom up reporting is needed.</p> <p>Based on the information received and the analysis performed by the (risk) department(s), a meaningful reporting to the COs is key to make risks transparent as well to propose and finally decide on mitigating measures.</p> <p>The CO should receive regular reporting on risk management (e.g. weekly or monthly) and the reporting should be holistic, i.e. entailing all risks categories identified.</p> <p>2. <u>BoD risk report</u> The Board shall receive a regular holistic risk report (e.g. on a monthly or quarterly basis) aggregating risk assessments, and including remedial measures taken that allows the Board to receive information on the adequacy and effectiveness of the risk management process.</p> <p>The conducting persons and BoD may receive similar information but with potentially varying level of detail – i.e.</p>

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	more detailed for conducting persons and major aspects for BoD.