UCITS and AIFs – Guidelines on Liquidity Stress Testing

Background

In April 2018, the European Systemic Risk Board ("ESRB") published a set of recommendations to address liquidity and leverage risk in investment funds. In February 2019, the European Securities and Markets Authority ("ESMA") published a consultation paper on draft guidelines on Liquidity Stress Testing ("LST") in UCITS and AIFs in order to fulfil the ESRB recommendations and to gather input from stakeholders. The consultation closed in April 2019.

In September 2019, ESMA provided a summary of the feedback it received and provided the final guidelines on LST in UCITS and AIFs. The guidelines are supplementary to the LST requirements in AIFMD and the UCITS Directive and should be applied proportionately in accordance with the nature, scale and complexity of each fund. ESMA's aim is to have a consistent framework for LST in all EU member states and to encourage convergence in the approach taken by supervisory authorities.

In August 2019, prior to the release of the ESMA final guidelines, the Central Bank of Ireland ("CBI") published an industry letter to CEOs of management companies highlighting the importance of liquidity risk management and LST in funds.

Two recent events in the industry have also increased the focus on liquidity management in particular by UCITS funds. They laid bare the risk of a liquidity mismatch between the time it takes to sell assets held by a fund and the daily redemptions offered to investors. These events are:

- The Woodford Investment Management case where the manager was forced to close a UCITS structure in October 2019 after it was unable to meet investor redemption requests.
- The H2O Asset Management case where the manager struggled to cope with sudden large outflows in early 2019 following media reports of the scale of its holdings in illiquid German bonds.

Obligations on Management Companies in the Final Guidelines

Under the guidelines, where a management company has delegated portfolio management to an investment manager, it must avoid placing reliance on the delegated investment manager's own LST. The management company must ensure that the delegate portfolio manager provides it with appropriate information to allow it to conduct appropriate LST.

The obligations placed on management companies in the final guidelines include a requirement to:

- adapt the LST to each fund
- have a strong understanding of the liquidity risks arising from the assets and liabilities of a fund's balance sheet and its overall liquidity profile
- integrate LST into each fund's risk management framework and ensure that it is subject to sufficient governance and oversight
- include an LST policy in each UCITS and/or AIF RMP which should include items such as:
  - a definition of the role of senior management in the LST process
  - the interaction of the LST policy with other liquidity risk management procedures and the portfolio management function

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  - a requirement for regular internal reporting of LST results specifying the frequency of and the recipients of the report
  - a provision for the documentation of LST results
  - the LST frequency and the reasons for selecting the frequency. It is recommended to employ quarterly or more frequent LST
  - circumstances requiring escalation, including where liquidity limits/thresholds are breached
- develop LST models which should factor in items such as:
  - risk factors impacting a fund's liquidity
  - scenarios to be used and their severity
  - outputs and indicators to be monitored based on the results
- ensure that the LST is adapted for each fund
- ensure that LST enables an assessment of the time and cost to liquidate assets
- employ hypothetical and historical scenarios and if appropriate reverse stress testing
- ensure (where appropriate) during the product development stage that LST is used on a model portfolio. This is to demonstrate that the relevant fund is structured so that it will remain sufficiently liquid during both normal and stressed market conditions.

Obligations on Depositaries in the Final Guidelines

The final guidelines require depositaries to set up appropriate verification procedures to check that the management company has documented procedures in place for its LST programme. The depositary is not required to monitor the quality of the management company's LST or to challenge LST undertaken by the management company.

Next Steps

Management companies are required to comply with the final guidelines by 30 September 2020 and ensure that they are embedded in their governance and operational risk models. National regulators may request management companies to submit their LSTs to prove that they comply with the relevant rules including demonstrating the ability of funds under management to meet redemption requests in both normal and stressed scenarios. Regulators will also have the ability to request information from management companies on LST models and the results of stress tests.

The expectation is that the CBI will notify ESMA of its intention to comply with the guidelines in full. In a speech delivered by Gerry Cross, CBI Director of Policy and Risk, at the Irish Funds UK Symposium in November 2019, liquidity risk in the non-bank sector was identified as a focus of the CBI and other regulators in the coming period.

KB Associates' Services

KB Associates offers a range of services to investment funds and management companies including:

- The provision of UCITS/AIF management company services.
- The provision of designated persons to perform UCITS business plan and AIFMD programme of activity managerial functions
- The provision of risk management services to proprietary management companies.

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