CBI UCITS Liquidity Risk Management Review – May 2021

Introduction

On May 18th 2021, the Central Bank of Ireland ("CBI") issued a letter to Irish authorised UCITS management companies, including self-managed UCITS ("UCITS ManCos") regarding liquidity risk management ("LRM"). UCITS ManCos will be required to carry out a review of their practices, documentation, systems and controls relating to LRM (the "Review"), to be completed and approved by the board of each UCITS ManCo by Q4 2021. The CBI notes that this letter should be read in conjunction with the European Securities and Markets Authority ("ESMA") public statement on the outcome of the Common Supervisory Action ("CSA") carried out on LRM in 2020 (the "ESMA Statement") along with the European Systemic Risk Board ("ESRB") recommendations on liquidity risks in investment funds.

Review

The CBI notes that the Review should have regard to the findings of the ESMA Statement along with the following specific findings identified by the CBI from their engagement with UCITS ManCos as part of the CSA:

- *Instances of LRM frameworks that were not clearly defined, adaptable and/or independent* – The CBI expects UCITS ManCos to employ a cohesive, comprehensive, practical, live documented LRM framework that accounts for all known dynamics relating to liquidity risk. LRM frameworks should be forward looking, adaptable and independent of unrelated external influence.

- *A lack of formal documented pre-investment forecasting frameworks* - A documented framework that sets out the expectations and required actions in respect of pre-investment forecasting forms an important part of the overall risk management policy with respect to LRM. UCITS ManCos are required to ensure that this framework is incorporated into their risk management policies and procedures and that it meets the standards for risk management policies set out in the Irish UCITS Regulations.

- *A lack of formal liquidity escalation policies* - UCITS ManCos must have a formal process in place with quantitative measures supported by qualitative judgements and clear responsibilities for the identification and escalation of liquidity issues and/or concerns to the board.

- *Cases where no pre-investment forecasting is performed* - In accordance with the UCITS Regulations, UCITS ManCos are required, where it is appropriate, to formulate forecasts and perform analyses concerning the contribution of individual investments to the UCITS portfolio composition, liquidity and risk and reward profile before carrying out the investment.

- *Over-reliance on the presumption of ongoing liquidity* - UCITS ManCos are required to conduct stress testing and scenario analysis, where appropriate. Moreover, the ESMA Guidelines on liquidity stress testing in UCITS and AIFs contain further granular guidance providing that UCITS ManCos conduct stress testing for future hypothetical scenarios, including exceptional liquidity events, which enable the assessment of risk under such conditions.

- *Oversight of delegates below expectations* - The CBI expects that UCITS ManCos have regular engagement with delegate investment managers through receipt of ongoing liquidity reporting and evidence of regular challenge and interaction with them.

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- *Shortcomings in the role of the designated person for fund risk management* - Designated persons are required to approach information received from delegates with healthy scepticism. They should not necessarily accept such information at face value and should interrogate information received. Designated persons should constructively challenge delegates and should follow up on issues raised to ensure that they are concluded satisfactorily.

- *Cases of no liquidity reporting to the board of the UCITS ManCo* - The reporting of liquidity risk and the manner in which it is reported to the board of the UCITS ManCo is an essential part of a properly functioning and robust risk management policy. In accordance with the UCITS Regulations, it is a requirement that the risk management policy of the UCITS ManCo must state the terms, contents and frequency of reporting to the board.

- *Shortcomings in internal control framework* - UCITS ManCos must ensure that second-level controls (e.g. compliance functions), and where appropriate and proportionate, third level controls (i.e. internal audit functions) have sufficient input into and oversight of LRM frameworks to ensure they are operating effectively. As per the UCITS Regulations, UCITS ManCos must establish, implement and maintain adequate internal control mechanisms designed to ensure compliance with decisions and procedures at all levels of the ManCo.

Actions Required

The Review must be completed and an action plan discussed and approved by the board of each UCITS ManCo by the end of Q4 2021.

KB Associates' Services

KB Associates provides a range of services to investment funds including:

- The provision of UCITS ManCo/AIFM services
- The provision of designated persons to perform UCITS business plan/AIFMD programme of activity functions.
- The provision of risk management services to proprietary ManCos.
- The provision of operational and compliance services to both UCITS and AIFMD compliant structures.

If you would like to discuss this note or KB Associates' services in general, please contact:

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