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ESMA Issues Final Liquidity Stress Testing Guidelines for UCITS and AIFs

[31939]

September 5, 2019 TO: ICI Members

Investment Company Directors

ICI Global Members SUBJECTS: Compliance

Exchange-Traded Funds (ETFs)

Fund Governance

International/Global

Investment Advisers

Money Market Funds

Portfolio Oversight

Risk Oversight

Systemic Risk RE: ESMA Issues Final Liquidity Stress Testing Guidelines for UCITS and AIFs

The European Securities and Markets Authority (ESMA) published its final report on liquidity stress testing (LST) titled *Guidelines on liquidity stress testing in UCITS and AIFs* (the “Report”) earlier this week.[\[1\]](#) The guidelines are intended to supplement UCITS’ and AIFs’ existing LST requirements and allow convergence in how National Competent Authorities (NCAs) supervise LST across the EU.

Background

In recent years, several international bodies have provided recommendations or guidance related to liquidity risk management (including LST) for open-end funds.[\[2\]](#) In April 2018, the European Systemic Risk Board (ESRB) published recommendations to address liquidity and leverage risk in investment funds.[\[3\]](#) This included a recommendation for ESMA to “develop guidance on the practice to be followed by managers for the stress testing of liquidity risk for individual AIFs and UCITS.” UCITS and AIFs currently are subject to LST requirements under their respective Directives.

This Report follows the consultation paper that ESMA issued in February, on which ESMA solicited comment.

Summary of the Report

The Report’s guidelines apply to managers, depositaries, and NCAs and relate to LST of UCITS and AIFs. Included in scope are ETFs, leveraged closed ended AIFs, and to some extent, money market funds.[\[4\]](#)

Substantively, the Report is not very different from the consultation paper, although it is organized differently. Whereas the consultation paper included 15 guidelines and separate “explanatory considerations,” the Report includes an annex containing guidelines (formatted in bold) followed directly by any related explanatory considerations.

The guidelines applicable to managers address the following topics:

- Design of LST models.[\[5\]](#)
- Understanding liquidity risks.[\[6\]](#)
- Governance principles.[\[7\]](#)
- LST policy documentation.[\[8\]](#)
- LST frequency.[\[9\]](#)
- Using LST outcomes.[\[10\]](#)
- Adapting the LST to each fund.[\[11\]](#)
- LST scenarios.[\[12\]](#)
- Data availability.[\[13\]](#)
- Product development.[\[14\]](#)
- Stress testing assets.[\[15\]](#)
- Stress testing liabilities.[\[16\]](#)
- Investing in less liquid assets.[\[17\]](#)
- Assessing assets and liabilities together.[\[18\]](#)
- Aggregating LST across funds.[\[19\]](#)

The Report includes one guideline applicable to depositaries, which states that a depositary should check that the manager has in place documented procedures for its LST programme.

The Report concludes by outlining how NCAs and managers may interact, suggesting that NCAs may request submission of a manager’s LST to help demonstrate that a fund will likely comply with applicable rules; that managers should notify NCAs of material risks and actions taken to address them; and that NCAs may request managers to notify them of other information relating to the LST, including LST models and their results (particularly during stressed market conditions).

Next Steps

The translation of the Report’s guidelines into the official EU languages will trigger a two-month

period during which NCAs must notify ESMA whether they comply or intend to comply with the guidelines. The guidelines will apply from 30 September 2020.

endnotes

[1] Available at https://www.esma.europa.eu/system/files_force/library/esma34-39-882_final_report_guidelines_on_lst_in_ucits_and_aifs.pdf?download=1.

[2] See, e.g., the Financial Stability Board's 2017 *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*, available at www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf; and IOSCO's 2018 *Recommendations for Liquidity Risk Management for Collective Investment Schemes* (available at www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf) and *Open-ended Fund Liquidity and Risk Management—Good Practices and Issues for Consideration* (available at www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf).

[3] *Recommendation of the European Systemic Risk Board on liquidity and leverage risks in investment funds*, available at www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation180214_ESRB_2017_6.en.pdf?723f0fa99b1e8886%20e651e4950d2a55af.

[4] Because money market funds are subject to separate liquidity-related regulation, they are subject only to those parts of the guidelines not already covered in the money market fund rules.

[5] Specifically, in building LST models managers should determine: risk factors that may impact the fund's liquidity; types of scenarios to use and their severity; different outputs and indicators to monitor based on the LST results; reporting of LST results, outputs, and indicators to management; and how risk management, portfolio management, and senior management use the results.

[6] Specifically, to employ a fund-appropriate LST, a manager should have a strong understanding of the liquidity risks arising from the fund's assets and liabilities and its overall liquidity profile. Also, a manager should balance the need for a focused LST (highlighting the fund's key liquidity risk factors) and a sufficiently broad LST (using a wide range of scenarios to adequately represent the diversity of the fund's risks).

[7] Specifically, LST should be properly integrated into the fund's risk management framework and subject to appropriate governance and oversight (including appropriate reporting and escalation procedures).

[8] Specifically, LST should be documented in an LST policy within the UCITS and AIF risk management process or policy (as applicable), which should require periodic review and amendment. The LST policy should address, among other things: the role of senior management; responsibilities of the parties; its interaction with other liquidity risk management procedures; internal reporting of LST results; periodic review, documentation of the results, and policy amendment; circumstances requiring escalation (including when liquidity limits/thresholds are breached); the funds subject to LST; initial validation of the LST models and assumptions underpinning them (which should be performed independently from portfolio management); types and severity of stress test scenarios used

and the reasons for selecting those scenarios; assumptions used relating to data availability for the scenarios, their rationale, and how frequently they are revisited; LST frequency and the supporting rationale; and methods for liquidating assets.

[9] Specifically, LST should be carried out at least annually and, where appropriate, employed at all stages in a fund's lifecycle. This guideline further *recommends* quarterly or more frequent LST, with the precise determination based on the fund's characteristics (e.g., its nature, scale, complexity, and liquidity profile).

[10] Specifically, LST should provide outcomes that: help ensure the fund is sufficiently liquid (as required by applicable rules and redemption terms); strengthen the manager's ability to manage fund liquidity in the best interests of investors; help identify potential liquidity weaknesses of an investment strategy and assist in investment decision-making; and assist risk management monitoring and decision-making (including setting relevant internal liquidity limits). This may include ensuring the results of LST can be measured through a comparable metric. Furthermore, LST should assist a manager in preparing a fund for a crisis, and in its broader contingency planning (e.g., operationalizing certain liquidity tools).

[11] Specifically, LST should be adapted to each fund, including with respect to: frequency; types and severity of stressed scenarios (which should always be sufficiently severe but plausible and based on the fund's specific liquidity risks); assumptions regarding investor behaviour (gross and net redemptions) and asset liquidation; complexity of the LST model; and in the case of an ETF, its specificities (e.g., the role of authorised participants, redemption models and replication models).

[12] Specifically, LST should employ hypothetical and historical scenarios and, where appropriate, reverse stress testing. The Report defines reverse stress testing as "a fund-level stress test which starts from the identification of the pre-defined outcome with regards to fund liquidity (e.g. the point at which the fund would no longer be liquid enough to honour requests to redeem units) and then explores scenarios and circumstances that might cause this to occur."

[13] Specifically, LST should demonstrate that a manager is able to overcome data limitations, including by: avoiding optimistic assumptions; justifying reliance on third parties' LST models; and exercising expert qualitative judgement.

[14] Specifically, during product development, a manager of a fund requiring NCA authorization should be able to demonstrate that the fund can remain sufficiently liquid during normal and stressed circumstances, and where appropriate, undertake LST on assets and liabilities.

[15] Specifically, LST should enable a manager to assess not only the time and/or cost to liquidate portfolio assets, but also permissibility, taking into account: the fund's objectives and investment policy; the obligation to manage the fund in the interests of investors; any obligation to liquidate assets at limited cost; and the obligation to maintain the fund's risk profile.

[16] Specifically, LST should incorporate scenarios relating to the liabilities of the fund, including both redemptions (incorporating risk factors related to investor type and concentration) and other potential liquidity risks on the liability side of the fund balance sheet, which could include those related to derivatives, committed capital, securities

financing transactions, and interest and credit payments.

[17] Specifically, LST should reflect the risks arising from less liquid assets and liabilities. As examples, the explanatory considerations mention real estate investments and investments in certain underlying funds.

[18] Specifically, after separately stress testing the fund's assets and liabilities, the manager should combine the results to determine the overall effect on fund liquidity. The explanatory considerations state that this could include use of a risk outcome or score (e.g., a redemption coverage ratio).

[19] Specifically, a manager should aggregate LST across funds under its management where it assesses such an activity to be appropriate for those funds. The explanatory considerations indicate that this "may be useful when considering the ability of a less liquid market to absorb asset sales were they to occur concurrently in funds operated by the manager" and that it "may be particularly pertinent when funds operated by the manager own a material level of assets in a given market."