A&L Goodbody

UCITS and AIFs Liquidity: Stress testing and management

On 2 September 2019, ESMA issued its final guidelines on liquidity stress testing in UCITS and AIFs. The guidelines become effective on 30 September 2020. They apply to UCITS Management Companies, SMICs, AIFMs and internally managed AIFs (Fund Management Companies or FMCs).

It is safe to say that liquidity for investment funds is a current priority on the regulatory agenda in Ireland and the rest of Europe, even though the effective date of the ESMA liquidity guidelines is 12 months from now.

In August 2019, the Central Bank of Ireland issued a letter reminding UCITS Management Companies, SMICs, AIFMs and internally managed AIFs (Fund Management Companies or FMCs) on the importance of ongoing and effective liquidity management. This was discussed in our August bulletin. We expect the Central Bank to notify ESMA that it intends to comply fully with ESMA's liquidity guidelines.

ESMA also published a stress simulation framework for the investment fund sector on 5 September 2019. The report is intended to help regulators to stimulate stress situations and could be referred to as a source of information on what a regulator might expect from liquidity stress testing (LST).

The ESMA liquidity guidelines cover all types of funds, including ETFs and leveraged closed-ended AIFs. ESMA accepts that LST for ETFs should be adapted to take into account their structure, including for example, the role of authorised participants, redemption and replication models. EU domiciled money market funds will only be subject to the provisions of the ESMA liquidity guidelines which are not already addressed under the Money Market Fund regulatory framework.

Existing liquidity requirements for Irish UCITS and AIFs

For UCITS, stress testing requirements are part of the statutory requirements to measure, manage and report on risk, including liquidity risk. Specifically, UCITS must conduct stress tests which enable assessment of the liquidity risk of the UCITS under exceptional circumstances. A UCITS does not have a specific statutory requirement to report the results of this stress test to the Central Bank. There are CBI reporting requirements for stress testing for a UCITS using VaR.

An AIFM must

i. conduct stress tests, under normal and exceptional liquidity conditions, which enable it to assess the liquidity risk of each AIF and monitor the liquidity of each AIF and

ii. employ an appropriate liquidity management system and adopt procedures which enable it to monitor the liquidity risk of the AIF (except for unleveraged closed-ended AIFs) and to ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations

The AIFM was always obliged to report the results of the stress tests in (i) to the CBI. The 2019 AIFM amendment regulations introduced a requirement to report to the CBI the results of the stress tests carried out in accordance with (ii).

Principles and proportionality

The ESMA liquidity guidelines set out a principles-based approach, acknowledging the diversity of fund structures. ESMA also accepts that the principle of proportionality should be applied and that LST should be tailored based on the nature, scale and complexity of each UCITS or AIF.

ESMA liquidity guidelines *16 guidelines applicable to FMCs*
Design of LST models
Understanding liquidity risks
LST governance principles
LST policy
Frequency of LST
Use of LST outcomes
Adapting the LST to each fund
LST scenarios
Data availability
Product development
Stress testing fund assets
Stress testing fund liability
LST on other liabilities
Funds investing in less liquid assets
Combined asset and liability LST
Aggregating LST across funds

LST where portfolio management is delegated

The ESMA liquidity guidelines state that where the FMC delegates portfolio management tasks to a third party, the FMC should avoid reliance on or influence by the third party's own LST. ESMA recommends that particular attention should be paid to the 'independence requirement'. LST should be performed under similar conditions to other risk management operations that are subject to regulatory requirements on independence, including the requirement for risk management staff to act independently from other functions such as portfolio management.

The feedback statement mentions that most respondents said that the delegating entity should be able to conduct effective LST, provided that the delegated portfolio manager collaborates and provides adequate information.

Depositaries

Depositaries will be required to check that the FMC has documented procedures in place for LST. The depositary will not have to assess the adequacy of the LST.

LST framework and policy

The LST framework implemented by a FMC should provide information that enables follow-up action. The FMC will need to put in place a LST policy within the risk management process of the relevant UCITS or AIF. The policy should address items such as oversight of the LST function, internal ownership, reporting structure within the FMC, procedure to review and amend the policy, the list of funds covered by the LST and the data and/or scenarios underpinning the LST.

Under the ESMA guidelines, regulators may request a FMC's LST policy or information about it.

Frequency of LST

The LST should be carried out at least once a year. The ESMA liquidity guidelines recommend quarterly and the FMC can decide to increase or decrease frequency depending on the UCITS or AIF's nature, scale, complexity and liquidity profile. Some examples of factors which can be considered when deciding on frequency are given

LST at product development

FMCs will need to demonstrate to their regulator that the UCITS or AIF sub-fund is structured so that it will remain sufficiently liquid in normal and stressed market conditions. LST should therefore be considered at FMC board level prior to fund launch on asset and on liability side, using expected investor profile.

Reverse stress testing

ESMA has included a recommendation to use reverse stress testing where appropriate. This is despite respondents to the consultation opposing the inclusion of reverse stress testing on the basis that it is not recommended under the UCITS or AIFM directives, is costly, and adds little value. ESMA will keep the matter of reverse stress testing under review.

Material liquidity risks

An FMC will have to notify its regulator of material risks and actions taken to address them.

Conclusion

FMCs will need to assess the requirements in the ESMA liquidity guidelines against their current liquidity risk management practices, policies and reporting before the 30 September 2020 deadline.

You can contact a member of the A&L Goodbody Asset Management & Investment Funds team for more information about the ESMA liquidity guidelines and to assist with the analysis and preparation of a LST policy for compliance by 30 September 2020.

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