ESMA RELEASES FINAL REPORT ON LIQUIDITY STRESS TESTING FOR UCITS AND AIFS

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UK Investment Management Alert

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On 2 September 2019, the European Securities and Markets Authority ("ESMA") published its final Guidelines on liquidity stress testing in UCITS and AIFs (the "LST Guidelines"). Managers will be required to amend their liquidity stress testing ("LST") arrangements to comply with the LST Guidelines by 30 September 2020.

Background

LST Guidelines follow the recommendation by the European Systemic Risk Board ("ESRB") in April 2018 that ESMA develop guidance for managers of funds that are undertakings for collective investment in transferable securities ("UCITS") and alternative investment funds ("AIFs") regarding the stress testing of liquidity risk for individual UCITS and AIFs.

Liquidity stress testing is mandated under the AIFMD [1] , the UCITS Directive [2] and the Money Market Fund Regulation ("MMF Regulation") [3]. The LST Guidelines are intended to clarify the process by which managers should carry out liquidity stress testing, and the considerations managers should take into account. The aim is to ensure a more uniform application of the LST rules, and a common approach to stress testing liquidity risk, across the European Union ("EU").

Scope

The LST Guidelines apply to:
(i) UCITS management companies (or in the case of a self-managed UCITS, the UCITS itself);
(ii) EU-authorised alternative investment fund managers ("AIFMs") (or in the case of an internally managed EU AIF, the AIF itself); and
(iii) depositaries of UCITS and AIFs [4].

Managers should note that the LST Guidelines will apply to a range of different types of UCITS and AIFs, including:

- exchange trade funds ("ETFs") (whether established as a UCITS or AIF);
- closed-ended leveraged AIFs; and

- money market funds ("MMFs") (whether established as a UCITS or AIF), although only certain guidelines are applied to MMFs, and in the event of a conflict with the MMF Regulation, the MMF Regulation shall prevail.

Proportionality principle

ESMA expects managers to apply the LST Guidelines on a proportionate basis, and specifies that "*these Guidelines should be adapted to the nature, scale and complexity of the fund*" [5]. Several of the individual LST Guidelines indicate ways the LST arrangements in place for a fund may be adapted and the relevant factors to be considered, such as in relation to the frequency of LST [6] and the stress testing of fund liabilities [7].

Overview of LST Guidelines

Amongst other things, the LST Guidelines address the following aspects of LST:

- When designing LST models, managers should take into account certain matters such as the risk factors that may impact a fund's liquidity, the types and severity of scenarios used, and how the results are used by management [8].
- Managers should have a strong understanding of a fund's liquidity risks and overall liquidity profile, and strike a balance by employing LST that is adequately focused and specific to a fund and also uses a range of scenarios that is wide enough to reflect the diversity of the fund's risks [9].
- Managers should ensure proper integration of LST into the risk management framework, and ensure appropriate governance and oversight of LST (including reporting and escalation procedures) [10].
- An LST policy should be included within the manager's risk management policy, and should address certain matters, including which funds are subject to LST, senior management oversight and responsibility for the performance of LST, and reporting, review and escalation arrangements [11].
- Regarding LST frequency, ideally LST should be employed quarterly or more frequently, but always at least annually. Factors that may increase the frequency of LST include higher unit dealing frequency, a complex investment strategy and a less liquid asset base. A highly liquid asset base and less frequent dealing in the fund's units may decrease the frequency of regular LST. LST should be employed at all stages of a fund's life cycle [12].
- Managers should use LST outcomes that help ensure the fund is sufficiently liquid, 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 [13].
- LST should be adapted appropriately to each fund, including by adapting the frequency of LST, the types and severity of scenarios used (which should be sufficiently severe, but also plausible), the assumptions regarding investor behaviour and asset liquidation, the complexity of the LST model, and in the case of an ETF, the specificities of ETFs [14].

- Managers should employ hypothetical and historical scenarios (whilst avoiding over-reliance on historical data) and, where appropriate, use reverse stress testing (which the LST Guidelines defines as "*a fund-level stress test which starts from the identification of the pre-defined outcome with regards to fund liquidity…and then explores scenarios and circumstances that might cause this to occur*" [15]). Examples of historical scenarios might be the global financial crisis of 2008-2010 or the European debt crisis of 2010-2012, while a hypothetical scenario might include a possible political event [16].
- LST should demonstrate the ability of a manager to overcome limitations relating to data availability, including by avoiding optimistic assumptions, justifying reliance on third parties' LST models, and exercising expert qualitative judgement [17].
- During product development, in the case of a manger of a fund that requires authorisation from a national competent authority ("NCA"), the manager should be able to demonstrate to the NCA that key elements of the fund, including its strategy and dealing frequency, enable it to remain sufficiently liquid during normal and stressed circumstances and where appropriate undertake LST on both the asset side and the liability side [18].
- LST should address the liquidity of the fund's assets and liabilities holistically, for example by ensuring that:
    - LST includes an assessment of whether the liquidation of fund assets is permissible having regard to factors such as fund objectives, the obligation to manage the fund in the interests of investors, and the obligation to maintain the fund's risk profile following liquidation of part of its assets;
    - LST scenarios relating to a fund's liabilities include all potential sources of risk to liquidity arising from fund liabilities (i.e. not just redemption requests), such as liabilities arising from the use of derivative instruments or securities financing transactions [19];
    - After assets and liabilities are separately stress tested, the results are appropriately combined to determine the overall affect on fund liquidity [20]; and
    - Where appropriate, LST is aggregated across the manager's funds. This could be a helpful activity where funds operated by the manager own a material level of assets in a particular market [21].

In addition, the LST Guidelines state that depositaries should set up appropriate verification procedures to check that managers have in place documented procedures for their LST programme [22].

Next Steps

Managers within the scope of the LST Guidelines should:

- review their existing liquidity stress testing arrangements and consider whether their practices and procedures need to be updated before 30 September 2020 in light of the final LST Guidelines;
- review, and update as appropriate, liquidity-related sections of UCITS risk management processes documents and/or AIF risk management policies; and
- monitor whether their relevant NCA has stated their intention to comply with the LST Guidelines, and whether the NCA provides any additional guidance or commentary at that time.

Who to Contact

Should you have any questions about the LST Guidelines in relation to your business, or wish to discuss the topic of liquidity stress testing further, do please reach out to one of the contacts below:

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NOTES

[1] Directive 2011/61/EU on Alternative Investment Fund Managers (as amended).

[2] Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (as amended).

[3] Regulation (EU) 2017/1131 on money market funds.

[4] Only certain guidelines are applicable to depositaries.

[5] V.1.3 of LST Guidelines

[6] V.1.5 of LST Guidelines

[7] V.1.12 of LST Guidelines

[8] V.1.1 of LST Guidelines

[9] V.1.2 of LST Guidelines

[10] V.1.3 of LST Guidelines

[11] V.1.4 of LST Guidelines

[12] V.1.5 of LST Guidelines

[13] V.1.6 of LST Guidelines

[14] V.1.7 of LST Guidelines

[15] Section II of LST Guidelines

[16] V.1.8 of LST Guidelines

[17] V.1.9 of LST Guidelines

[18] V.1.10 of LST Guidelines

[19] V.1.11 to V.1.14 of LST Guidelines

[20] V.1.15 of LST Guidelines

[21] V.1.16 of LST Guidelines

[22] V.2 of LST Guidelines

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