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# ESMA Guidelines on Liquidity Stress Testing

## Background

Following on from a consultation process earlier this year, ESMA has published its final report on guidelines on liquidity stress testing in UCITS and AIFs (the "**Guidelines**") which set down minimum standards for liquidity stress testing ("**LST**") in EU domiciled UCITS and AIF funds.

The publication of the Guidelines follows an increased regulatory focus on liquidity on a domestic front also. The Central Bank of Ireland (the "**Central Bank**") last month issued a "Dear CEO" letter to all UCITS management companies and AIFMs ("**Management Companies**")[1] noting that it expects the Board, relevant directors and designated persons of each Management Company to assess on an ongoing basis the liquidity position of each fund under management to ensure "that the liquidity of the investment portfolio remains in line with the respective fund's redemption policy, taking into account investors redemption demands". As part of its Brexit contingency arrangements, the Central Bank has also increased its monitoring of investment fund liquidity and redemption activity since January of this year.

We expect the Central Bank to notify ESMA of its intention to comply with the Guidelines in full.

## Existing framework

Under the existing UCITS framework, UCITS management companies are required to conduct stress testing where appropriate in order to assess the liquidity risk of a UCITS under exceptional

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[1] This also includes self-managed UCITS funds and internally managed AIFs

circumstances. The AIFMD framework is more onerous in that no appropriateness threshold is applied and AIFMs are required to "regularly conduct stress tests, under normal and exceptional liquidity conditions, to allow the AIFM to assess the liquidity risk of each AIF under management and monitor the liquidity risk of each AIF accordingly".

### What is the aim of the Guidelines?

The Guidelines supplement the existing legislative provisions to set down a common framework for LST carried out on EU domiciled funds and are intended to increase the standard and consistency of liquidity stress testing by Management Companies and to promote convergence in the way in which national competent authorities supervise fund liquidity stress testing across the EU.

### When do the Guidelines take effect?

Despite calls from industry for a longer transition period, the Guidelines will take effect from 30 September 2020.

### Do all funds fall within the scope of the Guidelines?

**No**. EU domiciled money market funds will only be subject to certain of the Guidelines which are not already addressed under the Money Market Fund Regulations ("**MMFR**") regulatory framework.

While EU ETFs fall within the scope of the Guidelines, they provide that the LST for such funds should be adapted to take into account the specifications for ETFs, including the role of authorised participants, redemption models and replication models.

Leveraged closed-ended AIF also fall within the scope of the Guidelines.

### One size fits all?

Given the diverse range of fund types, the Guidelines set down a principle-based approach to LST in order to allow Management Companies to tailor their LST framework taking into account the nature, scale and complexity of the fund(s) under management. Furthermore, the Guidelines provide that LST should be adapted appropriately for each fund by adapting, for example, the frequency of stress testing and the types and severity of scenarios used.

### What are the benefits of a good LST?

The LST framework implemented by a Management Company should provide information that enables follow-up action and should:

(i) help to ensure that the fund is sufficiently liquid;

(ii) allow the fund manager to manage fund liquidity in the best interests of investors;

(iii) help identify potential liquidity weaknesses of an investment strategy; and

(iv) assist risk monitoring and decision making

**I am a Management Company which has delegated portfolio management to a third party. Must I still conduct an LST?**

**Yes.** In its feedback statement, ESMA noted that LST must also be "performed robustly in the case of delegation". The Guidelines provide that Management Companies should avoid reliance on or influence by the delegated portfolio manager's own LST. Therefore any Management Companies which appoint an investment manager to manage the assets of a fund should ensure that the delegated portfolio manager provides them with adequate information to allow them to conduct appropriate LST.

**The Guidelines require that a LST policy should be put in place by Management Companies. What should that policy address?**

The Guidelines provide that the LST framework should be documented in an LST policy within the risk management process of the relevant fund. The policy should address, amongst other items, the following:

(i) the role of senior management in the LST process;

(ii) who within the Management Company is responsible for implementing the LST policy;

(iii) the reporting structure in place to communicate LST results within the Management Company;

(iv) circumstances requiring escalation, including where liquidity limits/thresholds are breached;

(v) the periodic review and adaptation of the LST framework where necessary; and

(vi) the types and severity of stress test scenarios used in the LST and the reasons for selecting same.

**Do the Guidelines set down any provisions relating to the models/scenarios to be used in the LST?**

**Yes**. As well as setting down certain factors which need to be taken into account in the design of the LST, the Guidelines also confirm, amongst other items, that:

(i) the LST models and assumptions underpinning them should be validated initially. This validation must be performed independently from the portfolio management function however the entity/person performing the validation need not be external to the Management Company;

(ii) both historical and hypothetical scenarios should be used. The LST should not overly rely on historical data given that future stresses may differ from previous stresses and historical data may not provide sufficiently severe examples of stressed conditions;

(iii) reverse stress testing should be used where appropriate; and

(iv) where relevant, risks arising from less liquid assets should be reflected in the LST.

### Should the LST focus only on the liquidity of the assets held by the relevant fund?

**No**. The LST must stress test both assets and liabilities of the relevant fund.

The liquidity of assets held in the portfolio should be stress tested using the liquidation cost approach and/or the time to liquidity approach. The LST should also allow the Management Company determine whether liquidation of a particular asset is at all possible, taking into account certain factors set down in the Guidelines.

The LST should also incorporate scenarios relating to any liabilities of the fund which are potential sources of liquidity risk. Such liabilities include not only redemptions but also derivative margin calls, committed capital to service an investment made by a fund and liquidity risk arising from factors such as interest rate sensitivity.

The Guidelines provide that once the assets and liabilities of the fund balance sheet have been stress tested separately, the Management Company should combine the results of the LST to determine the overall effect on fund liquidity.

The Management Company should aggregate LST across funds under its management where it considers it appropriate to do so for example where more than one fund has similar strategies or exposures.

### How frequently must stress testing be conducted?

While the Guidelines require stress testing to be conducted at least annually (which is the minimum frequency set down under AIFMD), they recommend that stress testing is conducted at least quarterly. The frequency of stress testing should be determined based on the nature, scale and complexity and liquidity profile of the relevant fund. The Guidelines detail some factors which may indicate that increased or decreased stress testing is appropriate.

Ad-hoc stress testing must also be carried out “as soon as practicable” if a material risk to fund liquidity is identified by the portfolio manager.

### Are there any specific considerations to be borne in mind during the product development phase of a fund?

**Yes.** Management Companies must be able to demonstrate to their competent authorities that the fund is structured so that it will remain sufficiently liquid during both normal and stressed market conditions. Where appropriate, LST should be conducted at the product development stage using a model portfolio. Management Companies may therefore wish to incorporate LST as a matter for consideration when approving new funds prior to launch.

### What happens if the results of the stress tests indicate a material liquidity risk?

If the stress testing identifies any **material** risks, the Management Company should notify its competent authority of same and outline the actions which will be taken to address them. The Guidelines do not provide any guidance on what is meant by "material" in this context.

### Are fund depositaries subject to any obligations under the Guidelines?

**Yes.** The LST will be required to verify that the Management Company has in place documented procedures for its LST. ESMA suggests that one way of verifying this is to confirm that the risk management framework of the relevant fund provides for the Management Company to carry out LST on the relevant fund. Depositaries are not required to assess the adequacy of the LST, nor are they required to challenge the LST undertaken by the Management Company.

### What next for Management Companies?

In advance of the Guidelines taking effect on 30 September 2020, Management Companies will need to:

(i) conduct a review of their existing infrastructure to determine what adaptations will be required in order to ensure that their LST framework allows them to comply with the Guidelines;

(ii) consider what sources they will use to gather the data necessary to perform the LST;

(iii) prepare a LST policy; and

(iv) where they have delegated portfolio management to a third party, ensure that they have a contractual right to access relevant portfolio information which they require to conduct their own LST.

Management Companies should note that they may, under the Guidelines, be required by their competent authority to submit their LST for its review.

If you require any further assistance with implementing the Guidelines, please contact your usual contact in the Dillon Eustace Asset Management and Investment Funds Team.

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