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ESMA's Report on ESRB Recommendations on Liquidity Risk in Investment Funds

Background

As all fund management companies will be aware, the Central Bank of Ireland (the “**Central Bank**”) and other competent authorities worldwide have become increasingly focused on the need for these entities to have appropriate and robust liquidity risk management procedures in place. For Irish management companies¹, this supervisory focus is evident from the publication of a Dear CEO letter by the Central Bank in August 2019 and the launch of a common supervisory action by ESMA on UCITS liquidity risk management in February 2020 which comprised of the issue of a detailed liquidity risk management questionnaire and, in certain cases, an onsite inspection of liquidity risk management procedures which took place in the first half of 2020.² New rules imposed on management companies relating to liquidity stress testing also entered into force in September 2020³.

The supervisory focus on robust liquidity risk management has unsurprisingly only intensified since the onset of COVID-19 with market conditions creating significant liquidity concerns for fund managers and regulators alike, particularly in the case of those funds with significant exposure to corporate bonds and real estate which could contribute to wider market disruptions. This led to the ESRB publishing a [recommendation](#) to ESMA in May 2020 requesting the latter to assess the ability of corporate bond funds and real estate investment funds to react appropriately to potential future adverse

¹ Management companies refer to UCITS management companies, self-managed UCITS, AIFM and internally managed AIFs

² Further information on this common supervisory action is available in our [client briefing on the topic](#)

³ Our client briefing on the ESMA Guidelines on Liquidity Stress Testing in UCITS and AIFS is available [here](#)

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shocks which could lead to a deterioration in financial market liquidity and valuation uncertainty.

In response to the ESRB's recommendations, ESMA, in coordination with EU competent authorities published a questionnaire to management companies of corporate bond funds and real estate investment funds, the results of which form the basis of the conclusions reached by ESMA in its [report](#) published last week (the "**ESMA Report**").

While the ESMA Report focuses on corporate bond funds and real estate investment funds⁴, the recommendations outlined will have broader application to all categories of investment funds, regardless of their asset class or investment strategy.

In this briefing, we consider the five "priority areas" identified by ESMA to enhance the preparedness of the funds to potential future adverse shocks. While none of the recommendations are addressed at management companies directly, it would be prudent for all management companies to assess their existing liquidity risk management measures in light of the ESMA Report given the ongoing enhanced scrutiny of national competent authorities in this area which is unlikely to abate for the foreseeable future, with ESMA noting in its report that continued oversight by national competent authorities being of "utmost importance".

1. Ongoing supervision of alignment of fund's investment strategy, liquidity profile and redemption policy

Under existing rules, Irish management companies must ensure the alignment between the liquidity profile of fund investments and the redemption policies of the relevant funds.

The ESMA Report requires the Central Bank to closely monitor liquidity risk to assess whether these rules are being complied with in practice. In particular, they are required to identify any misalignments between the liquidity profile of a fund's investments and its redemption policies, using all information at their disposal, including the fund liquidity profile established under the AIFMD reporting regime and through the reporting by fund administrators of significant redemptions to the Central Bank. Particular attention must be paid to funds investing in less liquid or illiquid assets.

As a result management companies should be in a position to justify the liquidity profile of each fund under management both when the relevant fund is first authorised but also through the life of the fund. In the event that the Central Bank identifies a potential liquidity risk mismatch, the relevant fund management company can expect to be required to change the fund's liquidity processes in order to improve liquidity risk management and eliminate any liquidity risk mismatch.

2. Ongoing supervision of liquidity risk assessment

National competent authorities must supervise the manner in which management companies assess liquidity risk.

⁴ Part 5 of the ESMA Report focuses specifically on the assessment of corporate debt funds while Part 6 focuses on those funds with significant exposure to real estate.

In its report, ESMA notes that certain management companies used “improper” methods to assess liquidity risk and failed to identify liquidity risk posed by items on the liability side of the fund’s balance sheet, including for example:

- (i) Margin calls which may increase cash needs in case of renewed heightened market volatility;
- (ii) Loan covenants in real estate investment funds; and
- (iii) The sale of assets at significant discounts in order to service redemptions (“**fire sales**”) which ESMA notes could carry a pro-cyclical effect.

Management companies should therefore be satisfied that the liquidity risk management framework in place identifies not only risks posed by redemptions but also other liabilities. Under existing rules, the liquidity stress testing framework must already incorporate all “relevant items on the liability side of the fund’s balance sheet, including items other than redemptions”.

3. Fund Liquidity Profiles

In its report, ESMA acknowledges that in order for national competent authorities to be able to identify funds that present potential liquidity mismatches or use improper methods to assess liquidity risk, access to data plays a pivotal role.

It restates its call in its [review of AIFMD](#) to harmonise the UCITS reporting regime with that imposed on AIFMs under AIFMD, noting that any such regime should also reflect the “specificities of UCITS”.

In addition, while noting the existing obligation imposed on AIFMs to report on funds’ liquidity profiles and the access that national competent authorities already have to such data, ESMA notes that AIFMs tend to interpret reporting requirements under AIFMD differently. As a result, it recommends that additional specifications on how liquidity profiles should be established and reported as part of the AIFMD reporting framework should be introduced as part of the AIFMD review.

As a result, both UCITS management companies and AIFMs can expect enhanced liquidity reporting requirements to be introduced as part of the overhaul of the existing legislative frameworks which are due to be adopted in Quarter 3 of 2021 and which we expect will be subject to a transitional period before becoming effective.

4. Increase the availability and use of liquidity management tools

Under current rules, the UCITS and AIFMD frameworks do not address the use of liquidity management tools (“**LMT**”) by management companies. As a result, the availability and use of LMT varies across the European funds industry with ESMA noting that reputational issues associated with the use of such tools may also deter management companies from using such LMT. The suspension of redemption is the only tool available to all funds in all EU jurisdictions.

In order to ensure “*the availability of LMTs, to promote investor protection and thus reduce the barriers to the use of these tools linked to the negative image they may have*”, ESMA has called for the introduction of a harmonised legal framework for LMTs. It notes that this should set down

specific rules relating to the required disclosures for the provision and use of LMT to ensure greater protection and consistency for investors.

It is worth noting that the Irish legal and regulatory framework already permits Irish management companies to avail of a range of LMT such as redemption gates, swing pricing, in-specie redemptions and anti-dilution levies provided that these are appropriately disclosed in the fund documentation. It will be interesting to see what changes, if any, will need to be made to existing rules to align them with those introduced under the revised UCITS and AIFMD regimes. In the meantime, to the extent that this exercise has not already been completed, management companies are encouraged to review existing fund documentation to assess the availability of LMT to funds under management. Where relevant, consideration should be given to revising such fund documentation to provide the management company with a full arsenal of tools to manage liquidity in the event of a deterioration in financial market liquidity in the future.

5. Supervision of valuation processes in stressed market conditions

Under existing rules, management companies are required to develop and implement appropriate and adequate valuation procedures.

However, in its report ESMA has noted that not all management companies have included provision to value their assets in stressed market environments. It sets down its expectation that valuation procedures should cover all market situations and should impose “*clear rules for the use of different valuation methods, and in particular the possibility to switch from one method to another under stressed market conditions*”. ESMA notes in particular that mark-to-model valuations should not be used where mark-to-market valuations provide a reliable value of the asset.

Management companies which delegate portfolio management should also satisfy themselves that the team in charge of valuation has sufficient knowledge, expertise and access to information to analyse the reliability of the sources used and in order to establish a fair valuation of the relevant portfolio.

Irish management companies can therefore expect increased scrutiny from the Central Bank on their valuation procedures and delegation arrangements pertaining to valuation. In this regard, management companies may wish to conduct a review of the valuation framework as a whole to ensure that it would stand up to regulatory scrutiny in the areas identified by ESMA in its report.

Conclusion

Irish management companies of corporate bond funds and real estate investment funds can expect increased scrutiny from the Central Bank in relation to the matters identified above over the coming months. It would be prudent for such management companies to conduct a review of their arrangements in light of the ESMA Report so that they are in a position to demonstrate their preparedness for potential future adverse shocks.

Should you have any queries in respect of the issues raised in this article, please do not hesitate to contact any member of the Asset Management and Investment Funds Department.

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