



association of the
luxembourg fund industry

LIQUIDITY STRESS TESTING CONSIDERATIONS FOR REAL ESTATE FUNDS

Introduction

According to the Commission Delegated Regulation 231/2013 (CDR) an Alternative Investment Fund Manager (AIFM) shall establish and implement quantitative or qualitative risk limits, or both, for each Alternative Investment Fund (AIF) it manages, taking into account all relevant risks, where liquidity risk is one of the risk categories which shall be covered (Article 44 (1) and (2)).

In addition, AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of each AIF under their management (Directive 2011/61/EU Article 16 (1)).

Article 48 (2) of the CDR specifies that the liquidity stress tests shall:

- (a) be conducted on the basis of reliable and up-to-date information in quantitative terms or, where this is not appropriate, in qualitative terms;
- (b) where appropriate, simulate a shortage of liquidity of the assets in the AIF and atypical redemption requests;
- (c) cover market risks and any resulting impact, including on margin calls, collateral requirements or credit lines;
- (d) account for valuation sensitivities under stressed conditions;
- (e) be conducted at a frequency which is appropriate to the nature of the AIF, taking into account the investment strategy, liquidity profile, type of investor and redemption policy of the AIF, and at least once a year.

This document shall serve as an aide-mémoire for the risk manager and aims at proposing a list of practical considerations suitable for liquidity stress testing purposes for Real Estate Investment Funds (hereafter “REIF” or “Fund”).

The practical considerations cannot be seen as an exhaustive list, nor can they be deemed to cover fund specific needs which shall be taken into account on a case-by-case basis. The results of the stress tests should be carefully interpreted and stress tests of several categories may interact and should be interpreted in conjunction with each other.

	Funds open for redemptions but unleveraged	Funds open for redemptions and leveraged	Funds closed for redemptions but leveraged *	Comments
Stress factor	Considerations			
Redemptions	<ul style="list-style-type: none"> ➤ Stressing with different redemption scenarios such as largest investor redeeming, type of investor redemption, redemptions based on historical experience or a redemption of a fixed percentage. 		<ul style="list-style-type: none"> ➤ Not applicable 	<ul style="list-style-type: none"> ➤ The redemption mechanism outlined in the fund documentation should be suitable for the fund and in line with the liquidity risk appetite of the stakeholders.
Asset liquidity / Time to exit portfolio	<ul style="list-style-type: none"> ➤ Which properties can be sold within a certain amount of time for an adequate price? 		<ul style="list-style-type: none"> ➤ Can the fund exit the investments before fund termination? 	<ul style="list-style-type: none"> ➤ To build a stress test requires understanding of the underlying market drivers and of the property liquidity profile and readiness of sale; ➤ For open ended funds, the result should be read in conjunction with the redemption stress tests to adequately assess the risk.
Debt**	<ul style="list-style-type: none"> ➤ Not applicable 	<ul style="list-style-type: none"> ➤ Will covenants be respected if underlying parameters change (for example, if rental income or valuation drops will the debt service coverage ratio or the loan to value covenants be respected?) ➤ Debt renewal (can debt be renewed? at what terms?) 		<ul style="list-style-type: none"> ➤ The stress test scenarios should be tailored to the covenants outlined in the legal agreements; ➤ Renewed debt may be at less attractive terms or not available.
Cash flow	<ul style="list-style-type: none"> ➤ Stressing the operational, investing or financing cash flows, depending on the type of fund (open/closed and income generating vs capital growth) ➤ Stress of acquisitions and capex on the available liquidity (VA/Oppportunistic Funds) ➤ Challenge the execution of the fund strategy (acquisitions, disposals, capital raising, distributions etc.) ➤ Example of operational cash flow stress: drop in income (due to high lease rollover which cannot be cured, tenant defaults, market factors...) and/or increase in costs ➤ Example of investing cash flow stress: not successfully selling properties, larger capex needs ➤ Example of financing stress: poor equity raising, investor default, non-refinancing of debt or increasing interest rates (if applicable) 			<ul style="list-style-type: none"> ➤ Cash flow stress testing can help to understand what the impact on distributions to investors is, should the stress scenarios materialize; ➤ The cash flow stress testing can help to understand what will have to go wrong for the fund to be in distress; ➤ Currency impacts can also be incorporated in the various stress scenarios; ➤ Cash flow stress testing can also be done at different levels of the structure.

* Unleveraged closed-ended funds do not require liquidity stress testing as per Directive 2011/61/EU Article 16 (1).

** Debt is the only type of leverage that has been considered for the purpose of this aide-mémoire, debt is typically the major part of the AIFMD leverage in Real Estate funds.



The Association of the Luxembourg Fund Industry (ALFI), the representative body for the Luxembourg investment fund community, was founded in 1988. Today it represents more than 1 300 Luxembourg-domiciled investment funds, asset management companies and a wide variety of service providers including depository banks, fund administrators, transfer agents, distributors, law firms, consultants, tax advisers, auditors and accountants, specialist IT providers and communications agencies.

Luxembourg is the largest fund domicile in Europe and its investment fund industry is a worldwide leader in cross-border fund distribution. Luxembourg-domiciled investment structures are distributed in more than 50 countries around the globe, with a particular focus on Europe, Asia, Latin America and the Middle East.

ALFI defines its mission as to “Lead industry efforts to make Luxembourg the most attractive international centre”.

Its main objectives are to:

Help members capitalise on industry trends

ALFI’s many technical committees and working groups constantly review and analyse developments worldwide, as well as legal and regulatory changes in Luxembourg, the EU and beyond, to identify threats and opportunities for the Luxembourg fund industry.

Shape regulation

An up-to-date, innovative legal and fiscal environment is critical to defend and improve Luxembourg’s competitive position as a centre for the domiciliation, administration and distribution of investment funds. Strong relationships with regulatory authorities, the government and the legislative body enable ALFI to make an effective contribution to decision-making through relevant input for changes to the regulatory framework, implementation of European directives and regulation of new products or services.

Foster dedication to professional standards, integrity and quality

Investor trust is essential for success in collective investment services and ALFI thus does all it can to promote high professional standards, quality products and services, and integrity. Action in this area includes organising training at all levels, defining codes of conduct, transparency and good corporate governance, and supporting initiatives to combat money laundering.

Promote the Luxembourg investment fund industry

ALFI actively promotes the Luxembourg investment fund industry, its products and its services. It represents the sector in financial and in economic missions organised by the Luxembourg government around the world and takes an active part in meetings of the global fund industry.

ALFI is an active member of the European Fund and Asset Management Association, of the European Federation for Retirement and of the International Investment Funds Association.

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