



## Liquidity Risk Framework in Investment Funds

### Recent regulatory enhancements

#### Introduction

Due to the new regulatory framework related to Investment Funds, the importance for managing Liquidity Risk and the adoption of relevant monitoring tools have increased. In this context, ESMA (European Securities and Markets Authority) requires UCITS and AIFs to implement the Liquidity Stress Test framework until September 2020.

Moreover, in order to address the high uncertainty brought by the current pandemic, the ESRB (European Systemic Risk Board) recommended ESMA to emphasize on the monitoring of Market Liquidity Risk in order for funds to be able to cope with potential increase in redemptions and a further deterioration of financial market liquidity.



**ESRB: “The sharp fall in asset prices observed at the onset of the coronavirus pandemic was accompanied by significant redemptions from some investment funds and a deterioration of financial market liquidity.”**



## Today’s economic challenges

The financial sector has registered a consistent increase in the volume of assets under management over the years. As a result, fostering the stability of the overall financial system requires the increasing attention of regulators with respect to investment funds.

In a context of extremely low interest rates, profitable opportunities may require funds to undergo investment strategies characterised by riskier asset classes.

Nevertheless, the high volatility environment driven by the COVID-19 pandemic has led to a sharp decline in asset prices and a deterioration in liquidity of financial markets, potentially impacting the ability of investment funds to cope with redemption requests.



## Regulatory milestones

In response to ESRB 2017 Recommendation on liquidity and leverage risks in investment funds<sup>1</sup>, ESMA issued the “*Final Report Guidelines on Liquidity Stress Testing for UCITS and AIFs*”<sup>2</sup> on the 2<sup>nd</sup> of September 2019.

The Authorities’ objective is twofold: (i) setting common standards for Liquidity Stress Testing (LST) to promote supervisory convergence and (ii) mitigating the liquidity risk to enhance financial stability. The ESMA Guidelines set down a principle-based approach to LST and will take effect from the 30<sup>th</sup> of September 2020.

Operatively, the LST shall support the assessment of the time to liquidate and

liquidation costs under adverse scenarios of redemptions.

In fact, UCITS and AIFs are characterised by an active and constant liquidity transformation that exposes asset managers to the risk of managing redemption requests leading to the quick and forced sale of less liquid assets. This would cause a further fall in asset valuation and contraction in market liquidity.

Asset managers, through an adequate assessment of the investment strategy and coherently with the nature of the fund, may be able to minimise the risk of forced sales of liquid assets via the timely use, during liquidity shocks, of liquidity management tools, such as the suspension of redemptions, redemption fees, swing pricing, redemption gates, and anti-dilution levies, as per ESRB recommendation.

Accordingly, in response to the Covid-19 pandemic, in May 2020 the ESRB published a set of Recommendations<sup>3</sup> stressing the importance of the timely use of liquidity management tools, especially for investment funds with significant exposures to less liquid assets and short redemption periods.

Besides liquidity management tools, the measurement and the monitoring of Market Liquidity Risk have been emphasised for funds to be able to respond in case of an increase of redemptions and further deterioration of financial market liquidity.

Accordingly, by October 2020, ESMA shall assess investment funds readiness to cope with additional adverse scenarios and implement the ESRB Recommendations.

<sup>1</sup> ESRB, Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment

funds (ESRB/2017/6).

<sup>2</sup>ESMA, Final Report Guidelines on Liquidity Stress Testing for UCITS and AIFs, September 2019.

<sup>3</sup> Policy measures in response to the COVID-19 pandemic.



## Liquidity Stress Test Implementation

By the 30<sup>th</sup> of September 2020, asset managers are required to implement the Liquidity Stress Framework, in accordance with the nature, scale and complexity of the fund.

From a Governance perspective, the LST should be performed at least annually, integrated in the fund's risk management framework and should be both supported by an appropriate oversight framework and duly formalised. The related policy shall be periodically reviewed and shall address roles and responsibilities, reporting and escalation processes, review occurrences and procedures as well as providing justification for the selected scenarios, the chosen frequency, and underlying methods for liquidating assets.

As for the Methodology, modelling approaches and underlying assumptions should be sound, documented and subject to a validation activity. Moreover, both historical and hypothetical scenarios should be employed. Additionally, scenarios for the liability side, shall consider redemptions and other types of potential sources of liquidity risks.

Results obtained separately on asset and liability side have to be aggregated across funds under management to assess the liquidation cost or time to liquidate of each security. From a compliance point of view, the asset manager should be able to demonstrate to the National Competent Authority (NCA) that the fund meets all the regulatory requirements and it is able to meet redemption requests under both normal and stressed scenarios.

Furthermore, the manager should notify the NCA in case of material liquidity risks and about the mitigating actions undertaken. NCA may also request information about the LST and its results.

The proper implementation of the LST framework would significantly improve the management of the liquidity risk as follows:

- Ensuring the fund is sufficiently liquid.
- Strengthening the ability of managing liquidity in the best interests of investors and in compliance with the fund policy.
- Identifying potential weaknesses of investment strategies and assisting in investment decision making.
- Driving the definition of disinvestment strategies and of relevant limits regarding fund liquidity.



## How can Deloitte help?

Deloitte's risk management team leverages on market intelligence and industry expertise when assisting you implementing a sound Liquidity Stress Test integrated within the Liquidity Risk Framework. Accordingly, in line with the various regulatory prescriptions, Deloitte offers hands on experience in supporting you to:

- Perform a gap analysis of both the liquidity stress testing policy and the whole Liquidity Risk framework to ensure full compliance toward regulation.
- Define and implement an integrated Liquidity Risk Governance covering the Liquidity Stress Test Policy, the Contingency Liquidity Plan and the Redemption and Liquidation Strategies.
- Design liquidity risk and stress tests methodologies in line with best practice.
- Review and validate methodology and stress test scenarios and assumptions underpinning them.
- Define and implement reporting and monitoring process and Liquidity Management tools.

- Provide training and continuous support on stress testing and liquidity risk procedures.



**ESRB: "Additional liquidity management tools, further supervisory requirements and tighter liquidity stress testing practices can address risks from liquidity mismatches."**

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