

## ICMA AMIC Response to ESMA consultation on draft guidelines for liquidity stress testing

### Introductory Comments

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus and both buy-side and sell-side representation. AMIC welcomes the opportunity to respond to this consultation by the European Securities and Markets Authority (ESMA) on Guidelines on liquidity stress testing in UCITS and AIFs.

AMIC has a long-standing engagement with regulators on risk mitigation in investment funds, covering leverage, liquidity risk and stress testing. AMIC has responded to four FSB/IOSCO consultations touching on these topics among others, in 2014, 2015, 2016 and 2017<sup>1</sup>. AMIC has also jointly with the European Fund and Asset Management Association (EFAMA) drafted a [research report](#) on liquidity risk management in investment funds, a [research report](#) on leverage in investment funds and AMIC and EFAMA launched a third [report on liquidity stress testing](#) on 8 January 2019.

In our joint paper on liquidity stress testing, AMIC and EFAMA stressed the need to avoid overly prescriptive one-size-fits-all solutions, owing to the heterogeneity of the European funds sector.

The key recommendations from our report were:

- We do not believe changes to Level 1 legislation are necessary at this stage. Given the robust EU regulatory framework, the role of regional and national authorities should be to focus on minimising operational impediments and facilitating asset managers' liquidity risk management tasks, by ensuring there is a broad availability of liquidity management tools at their disposal.
- A principles-based approach on LST governance and oversight is the best way forward.
- Proportionality is critical for setting the right framework for LST, allowing the heterogeneous fund sector to tailor stress tests to their respective investors and invested assets.
- While the availability of, and access to data with regard to underlying investors remains a key challenge, there is an important role for regulators providing further support to asset managers to obtain the appropriate information from a redemption risk perspective.

AMIC is pleased that the draft guidelines released by ESMA adopt a principles-based approach to liquidity stress testing and should allow for sufficiently flexible approaches across the EU investment funds sector.

### Responses to questions

**Q1: What additional costs and benefits would compliance with the proposed Guidelines bring to the stakeholder(s) you represent? Please provide quantitative figures, where available.**

It is very difficult to estimate costs for managers of hypothetical new guidelines. We would have preferred ESMA to estimate some ideas of cost to the marketplace to help model the impact. While we accept that it is hard for ESMA to conduct such estimates, off-the-shelf products do exist for data

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<sup>1</sup> For AMIC responses to systemic risk consultations, please see <https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Asset-Management/Specific-regulatory-issues/shadow-banking/>

reporting and modelling that could form the basis of an estimate. Off-the-shelf solutions at this point mainly focus on the asset side liquidity estimates.

From an industry perspective, the system build costs come where ad hoc requirements become systematic requirements.

It is also very hard to quantify potential benefits, especially as the access to data on underlying investors is so patchy.

**Q2: Do you agree with the scope of these Guidelines? Should certain types of funds be explicitly excluded from these Guidelines? Should MMFs remain in-scope of these Guidelines?**

We agree with ETFs and closed ended AIFs being included in the scope of the LST Guidelines, but particularly the liability testing should recognise the different distribution models and nature of liabilities of such products and allow managers to adopt a proportionate approach. So e.g. ETFs (and other funds) are sold on the secondary market, not direct to underlying investors. Considerations that are ETF specific, like number of brokers, role of APs and OLPs, etc. should be considered. This is not to say that ETFs or other specialised funds should be exempt from any particular guideline requirement, only that the requirements should take into account some specificities of the particular product such as the lack of direct redemptions.

AMIC does not believe MMFs should be in scope of these LST Guidelines as they are already subject to their own rules in the MMFR.

**Q3: Is additional clarity required regarding the scope of these Guidelines? Is additional clarity required regarding the meaning of 'nature, scale and complexity' of a fund? Are there circumstances in which it would, in your view, be inappropriate for a UCITS to undertake LST?**

We do not believe additional clarity is required regarding the scope of the Guidelines. The consideration of "nature, scale and complexity" is well understood and should be retained as such.

In general, there should not be circumstances in which a UCITS fund should not undertake an LST, although there may be reasons to modify the frequency and scope of such tests depending on the type of fund in question.

**Q4: What are your views on when the Guidelines should become applicable? How much time would managers require to operationalise the requirements of these Guidelines?**

The timeline for implementation should be sufficiently long to anticipate the need for managers to implement new systems, particularly where previous ad-hoc systems become systematic. We recognise that many elements of LST are already in use today, however, standard practice is currently focused mainly on the asset side. Due to lack of reliable data on the liability side, those tests are on a more ad-hoc basis and performed to the degree possible.

Our proposal is to include an 18-month delay to implementation from the time after Member States have told ESMA whether they intend to comply or explain with the guidelines, i.e. two months after adoption by ESMA. This period would be helpful to allow firms to introduce systems changes and to improve availability of data for the purposes of complying with any changed LST as a result of the Guidelines.

**Q5: Do you agree with the proposed approach of setting out a list of Guidelines all funds should follow, and the provision of explanatory considerations to help managers comply with those overarching Guidelines? Do you see merit in including some of the explanatory considerations in the final Guidelines?**

Yes, we agree with the proposed approach by ESMA. This is an approach that managers are already familiar with and is found to work well. We do not believe the explanatory considerations should be in the final Guidelines, rather considering that they are better placed where they currently are.

We note that Guideline 5(d) builds on Recital 61 of the AIFMD Level 2 Regulation when it talks about setting of limits regarding fund liquidity. We do not agree with the setting of rigid limits and the wording in Guideline 5d appears to see the setting of limits as mandatory. Firms should be free to set limits if they believe it appropriate for their funds, having regard to the redemption commitments of the fund and the requirements of investors, but should not be compelled to do so.

We are concerned that this Guideline could be understood to mean that LST should be mechanistically taken into account in decision making in the investment process, as it can be difficult to implement, particularly in scenarios which are unlikely to happen. Such a requirement could also unnecessarily con-strain the portfolio decisions of the investment manager to the detriment of investment performance and ultimately the returns experienced by investors. LST should be seen as an additional tool in the broader toolkit of liquidity management.

**Q6: Do you agree with the proposed Guidelines? What amendments, if any, should ESMA make to its proposed Guidelines?**

The Guidelines are well drafted at a sufficiently general level to allow for flexible approaches to implementation. Drafting amendments should be limited to the explanatory considerations, where we have some suggestions for additional clarification.

**Q7: Do you agree with the proposed explanatory considerations regarding LST of fund assets?**

Overall, we are happy with the way ESMA have drafted the guidelines and explanatory considerations. However, we have some concern with the use of the bid-ask spread as a single liquidity metric in the context of operational stress-tests. In our experience, while it is true the bid-ask spread is correlated to volatility, on its own the bid-ask spread is a poor indicator of traded volumes and the guidelines should reflect this (see the 2016 ICMA report “Remaking the corporate bond market” here <https://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/Remaking-the-Corporate-Bond-Market-250716.pdf>).

Furthermore, we propose that there should be some clarification in the way the language is used in the explanatory considerations. We are concerned with the possible interpretation that the only consideration of the manager should be unitholders when facing the possible need to sell an asset. While that may be the priority, there are other considerations, like other investors, access to markets, or the integrity of the marketplace as a whole. We think the explanatory considerations should be expanded to include such elements too.

Also, we think that the language in Paragraphs 24-26 should be clarified in the explanatory considerations to allow a combination of “liquidation cost” and “time to liquidity” where such a combination makes sense rather than an “either/or” approach. Currently Paragraph 24 rightly states

that other methods than the “liquidation cost” and “time to liquidity” are allowed, but it would be helpful to explicitly allow one or the other method, or a combination of those two methods.

We also have general concerns with the explicit reference to liquidation costs. Liquidity cost is inherent in the investment process. Calculating liquidity cost dynamically is an operational challenge and access to reliable data is very limited and there is little consensus on how to model it at the moment. Therefore, there is even more reason for ESMA to allow more flexibility for firms in Paragraphs 24-26.

**Q8: What are your views on the requirement to undertake reverse stress testing, and the use of this tool?**

Reverse stress testing can be useful for some funds, particularly AIFs in less liquid securities. However, we believe that while the general requirement can stay in the Guideline 8, the explanatory considerations in Paragraph 28 should note that this may be more useful for some funds compared to others.

We agree that there is a place for reverse stress testing in some situations, but the testing would need to be an appropriate tool for the particular fund and needs to be fit for purpose. Therefore, we consider that reverse stress testing should be one of the methods available for managers to use as part of their LST program where it is appropriate given the risk characteristics of the fund, but not a requirement in all cases. Explanatory consideration 28 should be amended to reflect these concerns.

**Q9: Do you see merit in providing further considerations for managers on the use of data relevant to asset liquidity, particularly in circumstances when data is scarce?**

We do not see what further considerations could be useful. The most useful aspect for UCITS funds and AIFs would be a consolidated tape for corporate bonds, which was not delivered in MiFID II. ESMA should focus on ways to deliver a consolidated tape to improve data quality for investment funds regarding assets they invest in.

**Q10: Do you agree with ESMA’s wording regarding the asset liquidation method used in the LST model? How would you describe the asset liquidation method used by you or the managers you represent?**

Generally, we agree with ESMA’s wording regarding asset liquidation, particularly in avoiding mandating a waterfall or vertical slicing method. However, as we stated in response to Question 7, we are concerned that the only consideration should be the unit holders in the funds (both redeeming and remaining). We believe this should be amended to “primary” concern and that other considerations, such as non-unit holding investors and market integrity should also be included in Paragraph 32 and elsewhere if relevant.

As we stated in the AMIC/EFAMA LST report on page 15, the asset liquidation methods used by AMIC members primarily use the vertical slice approach, but this can be modified depending on the circumstances in the fund. In some cases, a waterfall approach is better for both redeeming and remaining unit holders, and the market at large.

In addition, it would be helpful if the wording in relation to asset liquidation method in paragraph 32 could be modified. For example, “The method of liquidating assets in an LST should always accurately reflect how a manager would liquidate assets during normal and stressed conditions...” is

very rigid and should take account of the fact that other factors may lead to the method being modified in the actual event.

**Q11: Do you agree with ESMA’s wording regarding ‘second round effects’? What is your current practice regarding modelling ‘second round effects’?**

We do not have any specific comments on the ESMA language on second round effects, as we mostly agree with the concerns raised and the approach suggested although we have some general observations to make. We note that ESMA sets out a number of hypotheses including a downward liquidity spiral. The counter hypothesis is that in such a situation, asset owners who do not suffer from short term redemption calls, such as pension funds, insurance companies and sovereign wealth funds, may react to falling prices by buying securities. Hypotheses such as these can only be effectively modelled if broader data sets are available on investor behaviour. Where these data sets are not available managers need to carefully assess the added value of modelling these additional hypotheses.

Also, the text in Paragraph 37 reflects current practice regarding modelling second round effects, but we believe this is another opportunity to remind practitioners that although the primary consideration should be the investors in the fund, there are also broader considerations to bear in mind in second round effects.

**Q12: What are your views on the considerations on difficult to model parameters, such as price uncertainty? What is your current practice concerning this issue?**

We have no particular concern with the difficult-to-model parameters. AMIC members practice concerning price uncertainty is well reflected – it is a key concern in illiquid markets. However, it is worth bearing in mind that in previous scenarios where prices were in some cases non-existent (such as the financial crisis or the sovereign debt crisis, UCITS funds and AIFs did not experience dramatic periods of illiquidity or mass redemptions.

**Q13: Do you agree with ESMA’s considerations on LST in funds investing in less liquid assets? What amendments should be made to the proposed wording? Do you think that ESMA should outline additional and/or specific Guidelines to be made in any other fund or asset types, such as ETFs?**

We agree with ESMA’s considerations on LST in funds investing in less liquid assets and do not suggest any amendments to the wording.

Regarding the question for ETFs, we believe that there may be merit in reflecting some ETF specificities in the liabilities section of the explanatory considerations.

**Q14: Do you agree with the considerations regarding LST on items on the liabilities side of a fund’s balance sheet?**

Overall, we agree with the considerations ESMA has provided on stress testing liabilities. However, the overriding concern we have on liabilities is the persisting lack of accurate underlying data on investors. This is something AMIC and EFAMA have raised in the LST report on page 13-14.

We would like to propose that ESMA consider mandating access to investor data from intermediaries. However, it is important that such access should be free to avoid abusive commercial exploitation of client data by intermediaries.

We have two specific comments on the wording of the explanatory considerations:

- (1) The example of potential incorporation into LST in the first row of the table on page 41 suggests that funds of funds may pose more redemption risk than other types of investors – we do not agree with this and suggest it be removed; and
- (2) There is one important liability missing from the “LST on other types of liabilities table” on pages 42-43: bank borrowing. Some funds can use credit lines from banks, which is another liability that needs to be considered by the fund in its LST, since such credit lines can be suspended by the banks.

**Q15: Do you agree with the considerations specifying the LST of redemptions and other types of liabilities may need to be considered distinctly, given a fund could potentially limit redemptions but not other sources of liquidity drain?**

Yes, we agree with this approach, but would like to add borrowing as an additional “other type of liability”.

**Q16: Do you agree with the requirement to reverse stress test items on the liabilities side of the fund balance sheet?**

Yes, liabilities and assets are linked in the reverse stress tests currently undertaken and often modelled together rather than separately. However, while we agree that there is a place for reverse stress testing in some situations, the testing would need to be an appropriate tool for the particular fund and suitably adapted for the specific risk characteristics of the fund. Therefore, although reverse stress testing should be listed as one possible methodology that could be used, we do not agree this should be a requirement for all funds.

**Q17: Do you agree with the requirement to incorporate investor behaviour considerations into the LST model ‘where appropriate’? Are there cases which you believe it would not be appropriate, and should these be detailed in these Guidelines?**

We agree with the requirement to incorporate investor behaviour. Where a fund has institutional clients, such modelling is likely to be more accurate and helpful. However, as mentioned in our response to question 14, fund companies often lack data on underlying retail clients due to a lack of information from intermediaries.

There may be cases, for instance in closed-ended funds, where investor behaviour is less relevant, but we believe it should still be a consideration even in such circumstances.

**Q18: What do you think about ESMA’s Guideline stating that managers should combine LST results on both sides of the balance sheet?**

We agree with the principle of considering the impact of stressed conditions results on both the asset and liability side of the balance sheet, indeed this is common practice today. We agree that this is a sensible approach and it is already good practice for managers to combine LST results when looking at a “worst-case scenario”. However, we do not agree with the proposal of ESMA to compare LST results for more than one fund, if done over the whole universe of funds. We think that comparing LST results for more than one fund could only make sense between funds which share similar strategies and profiles.

We do not agree with the usefulness of comparing LST results from more than one fund within a company except in certain limited circumstances.

**Q19: What are your views on ESMA’s Guideline that aggregated LST should be undertaken where deemed appropriate by the manager?**

We do not agree with the usefulness of comparing LST results from more than one fund within a company except in certain limited circumstances.

If a company has funds with different client bases and segregated assets/liabilities then we question the usefulness of comparing LSTs from different funds. In most cases the relevant decisions have to be taken at an individual fund level. An aggregated test could potentially be used if the funds are managed by the same portfolio manager or portfolio management team where it is likely that managers want to assess liquidity and potential options where they run a common strategy but we do not see the benefit of comparison in general at the level of the management company especially where you have a multitude of fund styles, clients base and liabilities which are not comparable.

We do not think that Guideline 14 needs to be changed (as it contains the “where appropriate” qualification), but it would be helpful if the explanatory considerations could reflect the limited usefulness of aggregated LSTs where funds are not managed by the same portfolio manager or portfolio management team.

**Q20: What is your experience of performing aggregated LST and how useful are the results?**

As we state in our response to Question 19, unless several funds have similar strategies and profiles, aggregated LST have limited usefulness.

**Q21: What are your views on ESMA’s considerations concerning the use of LST during a fund’s lifecycle?**

We agree with the suggested Guideline and explanatory considerations on stress testing throughout the lifecycle of the fund, indeed this is already standard practice today.

**Q22: What is your experience of the use of LST in determining appropriate investments of a fund?**

LST can provide an additional consideration for determining the appropriate investments of a fund, but the primary input for such decisions come from the investment mandate and risk appetite of the fund.

**Q23: In your view, has ESMA omitted any key uses of LST?**

No, ESMA has captured the key elements of LST.

**Q24: Do you agree with ESMA’s Guideline that LST should be undertaken in all cases annually, but that it is recommended to undertake it at least quarterly, unless a different frequency can be justified? What is the range of frequency of LST applied on funds managed by stakeholder(s) you represent?**

We agree with the approach to require tests at least annually and if needed more frequently. However, we note the differing approaches between Guideline 4, which says “at least annually, but

more frequent if required”, and the explanatory considerations table on page 49 which says “quarterly, but more frequently or less frequently if justifiable”.

Some funds that are closed ended and invest in illiquid assets may not benefit from overly frequent stress tests. Similarly, without better access to data on underlying investors, overly frequent LSTs might have limited information value if only the asset side changes are captured. Asset and liability side information should be aligned time-wise to derive the highest information value from the stress test results.

Therefore, we believe the approach in Guideline 4 is the appropriate approach and should be reflected in the explanatory considerations.

**Q25: Should ESMA provide more prescriptive Guidelines on the circumstances which can justify a more/less frequent employment of LST?**

No, ESMA should not be more prescriptive. The fund sector is very heterogenous and need to be able to adopt a flexible approach regarding the frequency of LST.

**Q26: Do you agree that LST should be employed outside its scheduled frequency (ad-hoc) where justified by an emerging/imminent risk to fund liquidity?**

Yes, we agree. Indeed, it is already standard practice today.

**Q27: What are your views on the governance requirements regarding LST?**

We agree with ESMA’s approach on governance requirements for LST.

**Q28: Should more information be included in the UCITS RMP and AIF RMP?**

No, we do not believe LST requires additional information to be included in the RMPs. However, if firms want to include more information on their LSTs in their RMPs they should be free to do so.

**Q29: Do you have any views on how managers which delegate portfolio management can undertake robust LST, independently of the portfolio manager, particularly when the manager does not face the market?**

We do not have strong views on how LSTs are performed in a delegated portfolio management scenario, as practices differ across firms in Europe. However, for firms that use delegated portfolio management, the firm must apply appropriate due diligence and should agree on minimum requirements to ensure that data flows are sufficient to allow robust LSTs to take place.

Guidance on Master-Feeder set-ups can be helpful if the Master fund is domiciled in a jurisdiction where adherence to the guidelines is provided. The liability side of the Feeder fund is a fraction of the Master fund, whereas the asset side might not be visible to the Feeder fund.

**Q30: Do you agree with the proposed Guideline for depositaries on carrying out their duties regarding LST?**

We have no significant issues with Guideline 15 and the explanatory considerations for depositaries, merely noting that in many jurisdictions it is already mandatory for depositaries to review the RMP



of the UCITS or AIF. We recognise that in jurisdictions where this is not already taking place, it would be helpful if RMPs are made available to depositaries to help them fulfil their obligations.

**Q31: In your experience do depositaries review the UCITS RMP and AIF RMP as a matter of course?**

We do not have experience of depositaries review of RMPs, but as we said in our response to Question 30, RMPs should be made available to depositaries in order for them to fulfil their obligations, especially in jurisdictions where this is not already the case.

**Q32: Do you see merit in ESMA publishing further guidance on the reporting of results of liquidity stress tests? If so, in your view how should ESMA require that results be reported?**

We understand this question to refer to whether more guidance is need on how firms report the results of LST to their NCA. While there is merit in avoiding fragmentation between national practices on how LST are reported to the NCA, we would also want to avoid overly prescriptive harmonisation. Therefore, the current explanatory considerations should be sufficient to avoid too much divergence.

ENDS

28 March 2019