

ESMA GUIDELINES ON LIQUIDITY STRESS TESTING IN UCITS AND AIFS

New guidelines from the European Securities and Markets Authority (ESMA) on liquidity stress testing on UCITS and Alternative Investment Funds (AIFs) came into effect on the 30th September 2020. The Financial Conduct Authority (FCA) has not made specific reference to the new requirements on its website to alert fund managers that these new guidelines would be introduced.

The aim of the new guidelines is to establish consistent, efficient and effective supervisory practices, in particular with regards to increasing the standard, consistency and, in some cases, frequency of liquidity stress testing (LST) already undertaken by Full Scope Alternative Investment Fund Managers (“AIFM”), UCITS Managers and delegated MiFID Managers in respect of relevant funds. Firms can expect the Depository to be asking about their approach to LST and for sight of each funds’ LST policy as part of their ongoing oversight.

A link to the guidelines can be found here - [GUIDELINES](#)

ESMA sets out 16 guidelines for fund managers to follow. It is not a ‘one size fits all’ approach as the guidelines require the fund manager to take into account the specific characteristics of each fund that they manage. The guidelines cover, amongst others:

Design of LST Models – e.g. Managers should consider risk factors that can affect fund liquidity and the types of scenarios to use and their severity and how the results are used.

Understanding Liquidity Risks - a strong understanding of the liquidity risks of the fund’s assets and liabilities and overall liquidity profile to be able to carry out an appropriate LST. Adverse LST scenarios should be wide enough to reflect the diversity of risks with the fund.

Governance Principles – LST should be embedded in the fund’s risk management framework and be subject to appropriate oversight.

Frequency of LST - At least annually and employed at each stage of the fund’s lifecycle – The nature of the fund (closed versus open ended) and redemption policy should be taken into account.

An LST Policy – which should include, amongst others, the role of senior management / Board in the process; regular internal reporting and review of LST results; the circumstances requiring escalation, including when liquidity limits/thresholds are breached and the types and severity of stress test scenarios used and the reasons for their selection.

LST Scenarios – LST should employ hypothetical and historical scenarios and, where appropriate reverse stress testing which should simulate assets being liquidated in a way that reflects how the manager would liquidate assets during a period of exceptional market stress.

Stress testing fund assets to determine the effect on fund liquidity - LST to assess the time and/or cost to liquidate assets in a portfolio and whether such an activity would be permissible taking into account the objectives and investment policy of the fund; the obligation to manage the fund in the interests of investors; any applicable obligation to liquidate assets at limited cost; and the obligation to maintain the risk profile of the fund following liquidation.

Stress testing fund liabilities to determine the effect on fund liquidity - LST should incorporate scenarios relating to the liabilities of the fund, including both redemptions and other potential sources of risk to liquidity emanating from the liability side of the fund balance sheet.

Combined asset and liability LST – fund manager should combine the results of the LST on fund assets and fund liabilities appropriately to determine the overall effect on fund liquidity.

Funds investing in less liquid assets - Risks arising from less liquid assets and liabilities risks should be reflected in the LST.

If you require further information or assistance in putting together an LST Policy, please speak to your usual contact at Newgate.