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Liquidity Management: The Regulatory Spotlight Remains

Background

The regulatory spotlight remains firmly on the adequacy of liquidity management implemented by fund management companies with both the Central Bank of Ireland (the "**Central Bank**") and ESMA recently publishing communications on the need for fund management companies to effectively manage liquidity risk arising in the portfolios of funds under management.

The Central Bank, which had previously written to fund management companies in August 2019 and April 2020 reminding them of the importance of effective liquidity risk management, has published a **letter** which it has sent to fund management companies which were surveyed as part of an ESMA co-ordinated exercise last year which focused on the preparedness of funds with significant exposure to corporate debt to potential future liquidity shocks (the "**Central Bank Letter**"). The Central Bank Letter follows the publication of ESMA's report in November 2020 which outlined its findings from the review conducted on this category of investment funds which was discussed in our recent **client briefing**. While the Central Bank Letter was not sent to all fund management companies regulated by it, it has noted that the findings from the ESMA review "more broadly are important and should be noted by all firms[1]".

Central Bank Letter

The Central Bank notes in its letter that the review concluded that only a few funds had adjusted their liquidity set up in light of the liquidity issues encountered and that many funds "remain no better prepared for future liquidity shocks, periods of market volatility and increased redemptions than they were prior to the COVID-19

[1] https://www.centralbank.ie/regulation/markets-update/article/markets-update-issue-4-2021/central-bank-of-ireland/central-bank-letter-to-fund-management-companies

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outbreak". It also notes that in certain cases, the redemption frequency, notice periods and use of liquidity management tools applied by the fund management company were inappropriate in light of the liquidity profile of the assets held by the relevant fund.

While the Central Bank Letter outlines specific action which the Central Bank requires the cohort of fund management companies which received the letter to take in 2021, it has also identified the following as key considerations which we would suggest should be borne in mind by any fund management company when constructing or reviewing the adequacy of an existing liquidity risk management framework:

- The alignment between the liquidity profile of funds' investments, the risk profile of investors, redemption policies and settlement periods. The Central Bank Letter notes this is of particular importance for funds investing in less liquid assets or assets that have demonstrated variable levels of liquidity in 2020;

- The availability of a full suite of liquidity management tools ("**LMTs**"). The Central Bank notes that this should include the possibility of using LMT outside of stressed market conditions and considering whether the use of swing pricing or anti-dilution levies is appropriate in order to ensure that the effect of large redemption flows on remaining investors is limited;

- The firm's policies and procedures around the use of LMTs which should include appropriate disclosure in fund documentation and communication with investors to ensure clarity and transparency around the regular use of LMTs and conditions for their implementation;

- The assessment of all other factors that could impact fund liquidity or trigger unplanned sale of assets. The Central Bank provides the example of the possibility of increased margin calls that may increase cash needs in this regard;

- The use of a "realistic and conservative estimate of which percentage of a fund's assets can be liquidated over certain time periods" in order to determine redemption policies;

- The use of information on the profile of investor base in order to better understand any potential risks associated with redemption patterns; and

- The need to ensure that the design and testing of the liquidity management framework is not based on a presumption that there will be "government or central bank intervention of the nature or scale seen in 2020" in the future.

ESMA Findings on UCITS Liquidity Risk Management

Separately, ESMA has published a **statement** outlining its findings from the common supervisory action conducted by it and each of the EU competent authorities on liquidity risk management in UCITS management companies in 2020 (the "**ESMA Statement**").

While it found that in most cases UCITS management companies were complying with their regulatory obligations under the UCITS framework and have adopted "sufficiently sound" liquidity risk management processes, it has identified some shortcomings in the liquidity risk management arrangements of certain UCITS management companies.

It has called on all UCITS management companies to critically review their liquidity risk management framework to ensure that none of its "adverse supervisory findings" can be found in their existing processes and procedures. These include:

- Absence of documentation setting down the procedures to be followed relating to pre-investment liquidity analysis and forecasts, the design phase, escalation procedures and verification of data reliability;

- Failure to properly document liquidity risk management procedures generally or with respect to specific asset classes or use of LMT;

- Inappropriate risk management methodologies being used, including use of methodology which was not forward-looking or not justified and back-tested. ESMA notes in particular that the pre-investment analysis and forecasting in certain circumstances was inadequate and failed to consider all liabilities or investor behaviour analysis or failed to verify the accuracy of data used in the risk management framework;

- Over-reliance on the presumption of liquidity afforded to listed securities under the UCITS framework which included a failure to use reliable volume data to assess the liquidity of the relevant security, with ESMA noting that where there is no data on volumes, this should be taken as possible evidence that the relevant security may lack sufficient liquidity;

- Failure to conduct liquidity analysis or forecasting on those securities which fall within the "10% trash bucket";

- Lack of independent oversight of the liquidity risk management framework in circumstances where the monitoring of liquidity risk is being performed by a delegate;

- Inadequate processes in place to ensure that the data used in the liquidity risk management framework is "sound and reliable";

- Inaccurate or unclear, and in some case missing, disclosures on liquidity risks to investors via the UCITS prospectus and KIID;

- Reporting to senior management being infrequent or lacking granularity or clarity. In particular, ESMA noted that in certain cases, the analysis conducted during the design phase or the escalation of liquidity-related issues to senior management was inadequate;

- Inadequate second-level and third-level controls of liquidity risk management policies and procedures whereby both compliance and internal audit functions were not "performing sufficient control" with respect to liquidity risk management processes; and

- External controls by the depositary and, where relevant, external auditors to the UCITS and UCITS management companies are not performed in all cases[2].

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[2] ESMA noted that diverging national rules and practices regarding the scope of the audit may explain the fact that external auditors do not, in certain cases, perform external controls.

Consistent with the findings of the Central Bank outlined in the Central Bank Letter, ESMA notes that UCITS management companies in certain cases failed to adapt the liquidity risk management assessment in the changed market conditions arising as a result of COVID-19.

Conclusion

All Irish management companies should conduct a review of their existing liquidity risk management frameworks in order to assess whether any changes are required to be made to address the matters outlined in the Central Bank Letter, and in the case of UCITS management companies, in the ESMA Statement.

We are currently assisting a number of management company clients in reviewing the adequacy of their liquidity risk management frameworks. Should you require any assistance in carrying out a review, or 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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