Liquidity risk, a long-time concern in asset management

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Indisputably, liquidity risk is not a new topic in asset management. From a regulatory perspective, both UCITS and AIFM Directives release a set of requirements in relation to liquidity management which are designed to mitigate this risk. AIFM Directive, for instance, includes requirements and recommendations to the fund managers to put in place liquidity management processes and stress tests, especially for open-ended or leveraged funds.

Liquidity risk is subject to special attention and ongoing regulatory developments by regulators and supervisory authorities. We particularly refer to the liquidity risk management recommendations for investment funds published on July 18th, 2019 by the International Organization of Securities Commissions (IOSCO). The European Securities and Markets Authority (ESMA) also strongly focused on fund liquidity developments with, firstly, the overall markets understanding of risks, including the liquidity risk, via the data collected in the AIFMD reporting, which led to the publication of the first AIFMD statistical report on March 7th, 2019.

ESMA Guidelines on liquidity stress testing in UCITS and AIFs

Then, in order to fulfill the recommendations to promote supervisory convergence and to "develop guidance on the practice to be followed by managers for the stress testing of liquidity risk for individual AIF and UCITS" addressed to ESMA by the European Systemic Risk Board (ESRB), ESMA published on February 5th, 2019 a Consultation Paper on the draft Guidelines on Liquidity Stress Testing (LST) in UCITS and AIFs.

Following the consultation period, on September 2nd, 2019, ESMA published the final report on the Guidelines on liquidity stress testing in UCITS and AIFs, in a period when liquidity risk made the headlines: announcement of the suspension of the Woodford Equity Income fund and significant outflows for H2O Asset Management due to concerns over some bonds' liquidity. Such headlines enhance the importance of liquidity risk tools such as stress testing and carries a torch for the newly issued Guidelines.

Scope of the Guidelines and application date

These Guidelines will apply to both UCITS and AIFs, including leveraged closed-ended AIFs and ETF (whatever they operate as UICTS or AIFs) as from September 30th, 2020, giving Asset Managers a challenging 12-month implementation timeline to comply with the new requirements. Numerous respondents to the Consultation Paper suggested to exclude from the scope of the Guidelines all the closed-ended AIFs, whether they are leveraged or not. This is a strict reflect of most of the justification providing by AIFM to avoid performing stress testing in the industry. ESMA retained the leveraged closed-ended AIFs in the scope of the Guidelines considering LST is key to assess those fund's ability to meet margin calls or provide collateral.

A significant majority of respondents suggested an implementation period ranging from 18 to 24 months but ESMA considered that the 12-month timeline grants a sufficient implementation period to Asset Managers, considering the existing requirements on stress testing under both UCITS and AIFM Directives and the importance of ensuring convergence on how LST are performed by the industry.

Even though the Guidelines are a clear step further compared to the regulation in force, their implementation is not an impossible gap to overcome for AIFs considering the requirements on stress testing in AIFM Directive and the metrics to provide to their respective National Competent Authorities and ESMA via the reporting AIFMD.

Overview of the Guidelines from an AIF perspective

Governance principles and policy for LST

The manager should ensure that LST is properly integrated within the fund's overall risk management framework and is subject to appropriate governance and oversight.

LST must be performed by Risk Management, independently from portfolio management and other functions. However, the governance must ensure that the results of the LST performed are taken into account by the portfolio management and manage all potential conflicts of interest the performing of LST may face such as the undue influence of portfolio management over the execution of LST.

Liquidity Stress Testing should be documented in a dedicated policy within the Risk Management Process (RMP), which in turn is subject to periodical review and adaptation. It is a significant change compared to the Consultation Paper which recommended LST to be documented twice in both an LST policy, stand-alone, and the RMP.

LST design

In building LST models, managers should determine several factors mentioned in the Guidelines, such as the risk factors impacting the fund's liquidity, the type of scenarios to use and their severity or the manner the results are used by risk management. Behaviour considerations should also be incorporated within the models. Moreover, managers must ensure that LST provides information that enables follow-up and back-testing.

In performing LST, the Guidelines recommend employing both historical scenarios (for instance, the European sovereign debt crisis of 2010-2012) and hypothetical scenarios such as a double of the bid-ask spread, the impact of a low demand for private companies or even a state bankruptcy.

LST frequency

The Guidelines state, in compliance with the current AIFMD regulation, LST should be conducted at least annually and ideally on a quarterly basis, unless a higher or lower frequency is justified by the individual funds' characteristics including but not limited to the nature of the funds (closed vs open ended), the redemption frequency, the presence of gates and/or lock-up periods and the use of leverage.

This flexible approach should be documented in the LST policy (the detail of the frequency retained and the reasons motivating such choice) and close all the uncertainties raised by the respondents of the Consultation Paper regarding a "one-size-fits-all" approach. Characteristics of alternative universe also impose expert qualitative judgment and pragmatism.

LST on assets and liabilities' sides

The Guidelines consider time and cost-related asset liquidation as the two main approaches to simulate asset liquidity under normal and stressed conditions which is the principal tool of stress testing performed by the fund managers. The Guidelines also specify that other appropriate approaches could be applied by managers considering the nature, scale and complexity of the fund.

The major improvement outlined in the ESMA Guidelines concerns the need for the managers to ensure compliance with the investment objectives and restrictions of the fund. When employing a LST model on asset side, they must maintain the risk profile of the fund following liquidation of a portion of its assets and act in the best interests of all investors, both those remaining and redeeming.

Such obligation will lead to more realistic scenarios on how the assets will have to be liquidated under stress market conditions. Consequently, managers should not apply waterfall simulation of liquidation (the most liquid assets are sold first), as widely used in the industry, if it would result in a breach of the investment restrictions.

Regularly underestimated or set aside by managers, LST on liabilities side are subject to a strong focus in the ESMA Guidelines.

By liabilities side, ESMA certainly refers to redemption requests, the most obvious source of liquidity risk for investment funds, but also to other potential sources of liquidity risk arising from the liability side of the fund's balance sheet. Thus, even some closed-ended AIFs, especially leveraged ones, are concerned by such LST (i.e. simulation of increased interest rates on the payment debt obligation or determination of higher margin call than expected for derivatives in case of stress conditions). In private equity, divestment pace is likely to decrease during stressed conditions because of market liquidity drain. Monetization from exits may therefore be delayed and even impacted by discounts, especially on secondary market. For such funds, even if returns are not guaranteed to investors, distribution impacts the overall performance and should be considered. Liquidity risk evolves over the life of the fund and increase near the end. Hence, it might become less intuitive for managers to avoid LST on liabilities side justifying they are closed-ended.

The Guidelines recommend adjusting the scenarios depending on the market conditions considered. Under normal conditions, average and trends of historical outflows of the fund or average redemptions of peers could be used by managers whereas, under stressed conditions, the Guidelines propose using historical events, hypothetical & event-driven scenarios as well as reverse stress testing (RST).

Combined LST

Once the LST on both assets and liabilities sides have been carried out separately, the manager should aggregate the results to determine the overall impact on the fund liquidity. This combination is largely welcomed by the respondents of the Consultation Paper.

The Guidelines also propose to convert the combined results into a risk scoring or metrics, such as the redemption coverage ratio. In case of consistency in the model, comparability between funds with similar strategy, exposure or from the same manager is therefore possible.

For both UCITS and AIFs, the new ESMA Guidelines provide an additional step towards a better harmonisation between all market participants.

LST enhances the financial industry as a whole by implementing best practices and market standards in line with European vision. The requirements to perform LST on both assets and liabilities sides bring a new momentum that will make the LST more realistic. This will force managers to have an even better understanding of their funds, especially for AIFs investing in less liquid assets. We are not talking about Asset-Only approach anymore but are gradually converting to an inspiring Asset-Liability Management set-up, long adopted within the banking sector.

As a consequence, implementing such Guidelines might lead to higher costs due to the integration of additional tests and new considerations but also to obtain relevant and high-quality data.

These Guidelines impose a new way of considering liquidity risk with both quantitative and qualitative parameters. LST is becoming an effective management tool for managers to optimize their services in the best interest of investors.

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