association of the
luxembourg fund industry

ALFI Response to ESMA Consultation Paper on

Guidelines on liquidity stress testing in UCITS and AIFs

The Association of the Luxembourg Fund Industry (ALFI) represents the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We welcome being able to respond to the ESMA consultation paper on Guidelines on liquidity stress testing in UCITS and AIFs (the "Guidelines").

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.

ALFI would like to point out that asset managers of UCITS and/or AIFs are already required to perform periodic liquidity stress tests and stress testing has long been standard practice in the investment fund industry. However, the approach to liquidity stress testing (hereafter "LST") currently being undertaken by the fund industry does not comply with the proposed ESMA guidelines in all aspects.

The industry expects that there would be significant costs to implement these Guidelines and additional cost to support LST on on-going basis. It's important that LST guidelines remain principle based and leave sufficient flexibility to asset managers to design stress scenarios and choose between historical, hypothetical or reverse stress testing as deemed appropriate by the managers.

As an example, reverse stress testing is typically not performed regularly but rather on *ad-hoc* basis and often based on qualitative assessments. The reverse stress testing needs to be tailored for each fund and the process is very manual, difficult to automate. The implementation of this requirement may require additional staff, which can quickly result in significant increases to on-going costs.

A similar argument can be made for the stress testing of "other liabilities". Additional consideration should be given to the requirements to validate all assumptions which could also result in significant additional costs.

Furthermore, we would like to point out that although there are already components of the requirements through existing stress testing frameworks in place, not all of the requirements are implemented for all funds and some can only be implemented with significant effort or costs.

Several of the above, in particular "Reverse Stress Testing" or "Historical Stress Testing" would cause significant cost if they were to be implemented across the value chain. Parameters are often based on assumptions (given the availability of data). An independent validation of all estimates through an independent separate expert would cause significant additional costs.

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?

Where other sets of liquidity stress testing are already laid down, these requirements should prevail in order to avoid: i) duplication of work, ii) confusion by market participants and iii) leading to additional costs in relation thereto.

As regards **MMFs**, ESMA should be mindful of the interactions between these current Guidelines which may to a large extent be covered by the Money Market Funds Regulation (MMFR). ALFI believes that there seems to be no additional value to include MMFs is scope of these Guidelines.

In some cases industry participants think that there is no added value for performing this for **closed ended AIFs (leveraged or not).** The reason presented was that AIFs without the possibility to redeem prior to maturity that these should not fall within scope of the present Guidelines. Although liquidity risk does exist in these funds, the long investment horizon negates the need LST from a management point of view. In addition, we would like to point out that investors in such AIF are well aware of the risk arising during the liquidation phase (time to liquidate the deals at maturity)**.**

We believe that it would be useful to clarify how semi-open-ended funds (open-ended funds with a lock-up period) should be treated in scope of the guidelines.

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?

ALFI believes that the scope set out in the Guidelines is clear, we have made our observations in relation thereto in the response to question 2 above.

ALFI believes that It should be left to the discretion of the asset manager to assess the 'nature, scale and complexity' of a fund and for the manager to decide the most appropriate LST to be run as well as the periodicity of the stress tests. The asset manager will determine the relevant stress test scenarios based on the fund's investment strategy, risk profile and related liquidity risk. We believe that an emphasis on the "proportionality" should be inserted explicitly into the guidelines.

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?

Given the possible implementation complexity, the wide range of products and the differences in their liquidity profile, an implementation period of 18 months should be considered appropriate.

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?

ALFI agrees with the ESMA intention, see page 28 point 17. Guidelines, that the 15 guidelines should remain principles-based helping managers to integrate LST into their risk management and governance frameworks.

Flexibility is critical for setting an overall framework for LST, allowing the heterogeneous fund sector to tailor stress tests to the funds. There should be a clear room for asset managers to define internal standards within which they justify which Liquidity Stress Scenarios are relevant and applied for which fund ranges / products etc. The principle of proportionality should be considered. Explanatory considerations in the final Guidelines will be useful, however, the industry would welcome examples rather than the prescribed methodology.

Examples should be considered as necessary by ESMA to limit the room for interpretation and divergences between minimum standard implemented across the asset management industry. We would like to point out that the examples below are only to be implemented in case they are relevant:

- Gross Redemption Analysis (Guideline 7) Issue: Data Management
- Revers Stress Testing (Guideline 8) **– Issue: Systematic / Procedure Challenge**
- Historical Stress Testing (Guideline 8) – Issue: Data Availability
- Third Party Model reliance (Guideline 9) – **Issue: Resource / Effort**
- Cross linkage to other Indicators (Guideline 10) **– Issue: System constraints**
- Investor Profile / Redemption analysis (Guideline 12) **– Issue: Data Availability**

A maximum flexibility should be allowed for liquidity stress test as regards AIF, as guidelines will not be fit for purpose for all AIF given the vast range of alternative strategies.

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

We have raised specific concerns about the application of LST at pre-launched stage, analyzing of investor behavior, the reverse stress testing, the asset liquidation assumptions, limitations related to availability of data ensuring the fund compliance with investment restriction, analysis of other liabilities and aggregated LST in other sections.

As a general comment, we do appreciate the creation of a more robust and harmonized LST framework. Nevertheless we have the following comments on the proposed 15 Guidelines:

- The Guidelines are trying to harmonize the framework around the stress test calculation but do not try to do harmonize the methodology to assess asset liquidity. That would result in a set of heterogeneous methodologies developed by different asset managers and other market participants across the investment fund industry. As a consequence, even if the type of stress would be harmonized by the Guidelines, the results would not be comparable as different methodologies and assumptions could lead to completely different figures.

- We would like to point out that statistical data will not always be available for all asset classes in the AIF world and hence expert fund management judgement is pivotal.

- Even if we recognize the meaningfulness of the requirement, considering the investment compliance in the process of the liquidation of the assets might be extremely challenging especially for small organisations. It might drive towards an oversimplification of the models driving the liquidity monitoring and stress.

- While we agree that it is important to assess the quality of the information used, it would be very difficult and resource consuming to ensure independent validation of all assumptions in LTS. In particular, if the expert can be considered as independent from the Liquidity Management of the Fund and no conflict of interest is identified, this expert's estimate should be allowed to be used without explicit validation procedure by a second independent expert.

- The industry benefits from a high degree of automation already in place for stress testing scenarios. The systems would typically need to be adapted and may not be flexible enough to implement all changes provided. The cost sensitive nature of this was highlighted by members.

- We would like to point out that additional liquidity management tools, such as gates, may be considered in the design of the LST.

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

The explanatory considerations are useful to improve consistency in LST standards across jurisdictions and managers. With regards to the details of the content, in addition to the comments in other section we would highlight that a tradeoff between the standardisation and the flexibility in the approaches needs to be found to ensure that LST continues to be meaningful risk management tool and that the selection and the use of stress scenarios are relevant for each individual fund.

Investments in illiquid asset classes need to be considered in particular.

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

“Reverse Stress Testing” can be understood in different ways. On the one hand, as a pure quantitative concept within which an expected outcome is achieved by variation of a set of underlying parameters. On the other hand, it can be considered as a part of a qualitative assessment within the setup / configuration of a fund – and in particular during the configuration of the liquidity management tools implemented for a fund.

Due to the high complexity and the high dependency to data (in particular difficult to model data), we believe that quantitative reverse stress tests should be considered for a very limited set of situations and products (such as for MMFs). We would welcome if ESMA clarifies that reverse stress testing should be performed by managers only where deemed appropriate, for example: for the funds with high liquidity risk or in special circumstances because it requires an individual approach to each fund to identify various situations which could bring the fund to fail to comply with its liquidity obligations. This process would be difficult to automate for a wide range of funds and it would add limited value for this funds with low liquidity risk. In general RST have too many variables to have an accurate system built around it. This exercise will result too complex and too theoretic with a limited beneficial aspect in the day to day management.

The costs to implement a quantitative procedure as well as the limitations due to difficult to model data are not compensated by the benefit generated by the results.

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?

The requirement to simulate assets being liquidated in a way that reflects how manager would liquidate assets during a period of exceptional market stress is not available in practice since it would heavily depend on the type of stress and its impact on market liquidity and transaction costs of different assets in portfolio.

We believe that data availability and cost of data being available should be considered as a relevant factor during the setup of the requirements. Therefore, we believe that it is important to consider that the requirement to validate all the assumptions made, especially in relation to the expert estimates can result in significant additional cost for managers. We believe that proportionally should be taken in considerations especially if the subject expert is independent from portfolio manager and no conflict of interest identified.

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?

We would like ESMA to revisit the wording regarding the asset liquidation method, especially for what concerns the accurate reflection of how a manager would liquidate assets during normal and stressed conditions. The asset liquidation method could vary across time, based on different specific situations, and across managers, based on each manager’s own way of looking at his/her portfolio. Trying to accurately model these different behaviors will not only provide a false sense of security (especially considering that the actual liquidation process could be extremely different compared to the model), but also results in overcomplicated reporting for liquidity stress testing, as these methods will have to be fully customized across time and across funds.

ALFI does not agree with the requirement that LST models should reflect how a manager would and does liquidate assets during normal and stressed conditions. Such method would heavily depend on the stress situation and current holdings of the portfolio, their liquidity and transaction costs. The modelling would be too complex and involve too many assumptions and therefore the results would be not very reliable and of limited use. Using different methods for various funds would also decrease comparability of results. In many situations, for example for liquid funds, it can be sufficient to apply both waterfall and pro-rata methods and look on the combination of both results to have a view on possible outcomes in stress situation.

From a cost/benefit perspective, we do not think this is a valid proposition. Our suggestion would be to favor an approach where ESMA provides, in the explanatory considerations, one or two standard approaches (namely the pro-rata and waterfall ones, which are reasonably well recognized by industry participants as well as by regulators) and suggests using them together with a consideration on how things can change in case the manager vary the liquidation method used.

Q11 Do you agree with ESMA's wording regarding 'second round effects'? What is your current practice regarding modelling 'second round effects'?

While we generally agree with the description of this phenomenon, we do not think that a requirement to incorporate it in the LST process is adequate, also considering that there is contention in relation to this concept (as highlighted in the Consultation Paper itself). ALFI believes that second round effects are difficult to model explicitly / separately. We believe that those should be considered while defining the Stress Scenarios, but should not be required to be modelled separately. We also note that limited academic research exits on the topic, which deals mostly only with financial instruments with sufficient market data. The potential requirement of modelling this feature would create major challenges, especially for instruments where the data is scarce.

Moreover, we see second round effects as being better captured in the context of market stress testing (current market practice) instead of liquidity stress testing.

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?

Price uncertainty is an important aspect closely related to LST factors such as transaction cost and liquidation period. We would not recommend considering it as a separate factor in the LST, but rather indirectly within the other parameters included within the liquidity modelling. Price uncertainty can be considered in contingency planning and in application of extraordinary liquidity management tools.

We make reference to our previous answer, see response to question 11, we strongly believe that market stress testing should be separated from liquidity stress testing and that LST should focus only on liquidity factors.

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?

Establishing the LST for funds investing in less liquid assets would require even more thorough analysis and consideration than for liquid funds due to the very fund specific nature of "other liabilities". Contingency planning prior the forthcoming redemptions may be particularly important for these funds.

For ETFs, we do not believe that specific considerations need to be mentioned here. All specific characteristics of an ETF as well as the related implications on Liquidity Risk (e.g. Pro-rate constraints) are known by market participants.

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

We agree that the LTS should apply to fund's assets and liabilities. The Guidelines require to consider the other liabilities described within the section 7. We believe that such liability needs to be considered only if they have a material impact on the fund's liquidity. Discretion should be left to the asset manager. A material impact on the fund's liquidity can be often identified already during the pre-launch stage when determining the fund risk profile. We recommend that managers should define within the liquidity profile of the fund whether they expect these factors to have a significant impact on the liquidity profile of the fund and where it is expected to be less material. Given the outcome of this profiling, the LST can be restricted to the factors with material impact to avoid large data exercises without meaningful impact on the fund liquidity.

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?

We believe that the managers should be given flexibility to decide how these liabilities would be included in the LST. In some cases, it could make sense to look at the different types of liabilities separately.

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

We believe that asset managers should have a discretion to apply the reverse stress testing. We also would like to make reference to our response in questions 6 and 8.

The implementation of RST is a very erroneous exercise involving an assessment of a large number of factors that specific to each fund, which is being complicated by the absence of an accepted market standard model for measuring liquidity risk.

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 believe that the consideration of "investor behavior" could make sense but imposes a huge challenge in terms of aggregation and management of investor information. Due to the diverse distribution setups existing within the industry, and the lack of data exchange standards between intermediaries, asset manager and transfer agents, the consideration of investor behavior within the Liquidity Risk Models cannot be implemented without causing significant implementation and data maintenance costs.

The data on the type of investors is not always available/reliable. A number of information on the factors mentioned in the Consultation Paper (including investor category, investor origin, investor strategy and even, to a certain extent, Investor concentration) are not always available or, when available, they are available in an unusable format, making them ill-suited for utilization in an automated model run over tens (or hundreds) of funds.

The assumptions in relation to the investor behavior are difficult to validate. The results of the incorporation of investor behavior considerations might be of limited value and would require significant implementation and maintenance cost. Therefore, we believe that these requirements can only be implemented if there would be an established framework to allow to exchange in a standardized way at least for investor data. The emphasis could be placed on the availability of data (mentioned in paragraph 45) as well as the feasibility of the entire exercise.

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

We generally agree that managers should look on the LST result on both the assets and the liability sides. However when combining the results the approach should be tailored to each individual fund and no *one-fits-all* criteria should be adopted to assess the results of the combined LST. We do not find the example of a redemption coverage ratio to measure the ability of a fund's most liquid assets to meet short term liabilities useful, because the use of most liquid assets is not typical and, in many cases, not an appropriate method to meet redemptions. For example, high yield bond funds could have a low exposure to most liquid assets but have enough sufficiently liquid assets in the portfolio to meet redemptions.

It makes more sense to compare them in a similar way to what is done (for non-stressed conditions) within the AIFMD Regulatory reporting, where portfolio liquidity is compared to investor liquidity and liquidity mismatches are identified. We agree that there could be some value in the combination measures included in the Consultation Paper (with specific focus on the redemption coverage ration), but we do not think that the Guidelines should be prescriptive in this respect. Linked to this, we do not necessarily think that the next step in this process (comparing LST results from more than one fund) add value in the way it is presented (i.e. by combining the assets and liabilities sides) as redemption dynamics could be very different for different funds. We still believe that it could potentially make sense to compare different funds based on the LST results on the asset side.

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

We see limited benefit in aggregating stress test results. The aggregation would not bring additional value since most funds are set up as separate legal structures and there is no interconnectedness across funds   Investors in one fund would not have access to liquidity in another fund and managers cannot use assets of one fund to meet the liabilities of another fund. The holistic assessment of liquidity risk from an assets and liability prospective cannot be therefore done in aggregation.

Aggregated views of liquidity of asset across funds with a similar strategy could have some added value from a strategy capacity perspective however it would impose significant additional effort. Therefore, a cost benefit aspect should be considered.

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

Aggregated LST are performed only on an ad-hoc basis by some asset managers. Those who indicated that they undertake aggregated LST typically only do so for funds with the same strategy that are managed by the same team.

Some members have outlined that the results are discussed during board meetings. Generally it was felt that it is difficult to take actions given the theoretical nature of the results.

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

We generally agree that different form of LST can be used during a find's lifecycle. However, we believe that it is not reasonable to perform quantitative analysis based on an explicit model portfolio pre-launch. The pre-launch stage involves various critical assumptions such as target portfolio size, target investor base etc. Therefore, the application of quantitative LST can be of limited benefit. The qualitative assessment of liquidity risk on the other hand is very important at this stage. Special considerations should be given to availability/applicability of additional liquidity management tools.

Liquidity management tools go hand in hand with product configuration considerations such as (Notice Period, Redemption Frequency, Lock up Period, Open vs. Closed ended) that need to be defined

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

We think that the use of LST is important in the product development phase of a new fund and that the results of the LST should be used as an input in the process.

However, we see a limited value in the use of Liquidity Stress in determining appropriate investments of a fund. Typically, the appropriate investments are driven by other considerations such as the fund's investment policy, the investment restriction and the investor profile.

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

All relevant situations have been mentioned by ESMA. It is however believed that Liquidity Stress testing is not useful in each of the mentioned situations. For example, in times of Liquidity Stress, it is important that the relevant liquidity management tools are in place and that in these scenarios the required procedures are in place.

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 believe that the LST should be performed at least annually. It could be performed more often if appropriate to the nature of the fund (for example, for funds with daily redemptions, for funds with high liquidity risks) or specific other circumstances. However, the cost/benefit analysis should always be borne in mind.

In this relation some managers have outlined that when LST is done on a weekly basis, the results would be analyzed more in-depth on a monthly basis. Discretion should be left to the manager.

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

We believe that such circumstances should be determined by managers.

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

ALFI agrees that this can be considered at the discretion of the manager. We believe that in the period of an emerging/imminent risk it could be already too late/impossible to take actions driven by the LST results. We believe that more focus should be given to developing an appropriate contingency planning and to availability of additional liquidity management tools.

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

We generally agree with the considerations and recommendations regarding the governance of the LST. However, we would like to refer to the comment made on the "validation" activity related to the expert estimates included within the model. In case of expert estimates are involved in the assessment, it could be sufficient to ensure that no conflict of interest is being identified for the expert selected, this estimate should not be required to be validated by a separate expert.

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

We believe that this point is sufficiently addressed in domestic law. We would like to make reference to CSSF Circular 18/698 on the authorisation and organisation of investment fund managers incorporated under Luxembourg law. It should be sufficient to include the overall LST program including the information mentioned within point 69 CSSF Circular 18/698 of the guidelines document into the risk management process (RMP).

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 believe that managers can use the data provided by independent functions such as Trading Departments and external parties in their analysis.

We think that a robust LST process should be reasonably independent of the portfolio manager in all circumstances, no matter whether the portfolio management activity is delegated to a third party or not. However, in all circumstances, portfolio managers should have a duty to collaborate to ensure that the process is based on actual market information and behaviors. In case the portfolio management activity is delegated, an adequate communication and interaction framework should be put in place to ensure that this is the case.

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

We welcome the proposed Guideline # 15 which does not require depositaries to re-perform LST function undertaken by the fund manager. The role of the depositary is to be understood as a supervision role and therefore, it should ensure that appropriate processes are in place rather than double-checking and/or duplicating the LST process as implemented by the management company. Depositaries should only check that managers have declared that a LST program is in place.

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

As part of its due diligence on management companies, the depositary typically ensures that the UCITS / AIF RMP are in place. However, it is not a common practice for Depositaries to review these RMPs.

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 believe that it would be beneficial to introduce a minimum standard to LST in order to promote consistency across different jurisdictions and managers. However, managers should be given sufficient flexibility in a design and application of LST. It would be difficult to capture a variety of LST in one single reporting format. On the other hand, the results of the different LST cannot be compared between the funds. Even if LST might differ for different asset classes or fund structures (e.g. UCITS vs. Illiquid AIFs), it would be beneficial to define a European standard to avoid multiple implementation projects within the different countries. This simplifies and reduces the effort for service providers and asset managers and will enable to compare the results for similar funds on a European level.