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PUBLIC STATEMENT

ESMA presents the results of the 2020 Common Supervisory Action (CSA) on UCITS liquidity risk management

Background

1. On 30 January 2020, the European Securities and Markets Authority (ESMA) launched a Common Supervisory Action (CSA) on UCITS liquidity risk management (LRM). The purpose of this exercise was to simultaneously conduct coordinated supervisory activities in 2020 and to assess whether UCITS managers comply with their liquidity management obligations. In doing so, the CSA also allowed for ongoing exchange of supervisory knowledge and experiences among NCAs at the level of ESMA.

2. This CSA was an important exercise aimed at shedding light on and mitigating the supervisory risks and concerns identified in the area of UCITS liquidity, this was before the outbreak of COVID-19, in particular taking into account:

   - ESMA's stress simulation[1] applied to 6,000 UCITS bond funds, which showed that under severe, but plausible, shock scenarios, up to 40% of the 297 high-yield bond funds covered[2] could experience a liquidity shortfall i.e. a situation in which their holdings of liquid assets alone would not cover the redemptions assumed in the shock scenario and recourse to less liquid assets would need to be taken;

   - recent market incidents indicating that there might be a mismatch between the redemption policies and liquidity profiles of some UCITS, may also reveal non-compliance with the applicable UCITS liquidity management rules; and

   - systemic risks concerns expressed by the ESRB[3] and ECB[4].

3. Effective liquidity management is important for the protection of investors, maintaining market integrity and reducing systemic risk, all of which supports financial stability. Against this background, ESMA saw merit in using the CSA exercise to investigate whether UCITS managers across the EU/EEA have sufficiently sound liquidity management practices in place. In this context, it was important to follow an ambitious approach regarding both the CSA methodology and the overall coverage, in order to ensure the credibility and effectiveness of this exercise. This would also allow NCAs to

[1] ESMA Stress Simulation Framework for Investment Funds (September 2019).
[2] High-yield bond funds accounted for 297 funds out 6 598 funds of the sample analysed by ESMA (ESMA Stress Simulation Framework for Investment Funds).
[3] EU Shadow Banking Monitor (No 3/September 2018).
[4] ECB Financial Stability Review (November 2019).

get a comprehensive market overview, including more detailed insights into the practical implementation and quality of LRM processes. The outbreak of the COVID-19 crisis gave further impetus to deepening the exercise.

4. The CSA has been performed based on a common methodology developed at ESMA level in 2019. The CSA assessment framework, including scope, methodology, supervisory expectations, and timeline is the result of a joint effort to carry out comprehensive supervisory action in a convergent manner.

5. The first stage of the CSA involved NCAs requesting and analysing quantitative data from a large majority of the UCITS managers based in their respective Member States, to get an overview of the supervisory risks faced.

6. In the second stage, NCAs focused on a sample of UCITS managers and UCITS to carry out more in-depth supervisory analyses.

7. The CSA was conducted using the common methodology and was supplemented with the benefit of NCAs knowledge of UCITS in the relevant Member States. This allowed a common approach to be applied while ensuring NCAs targeted the appropriate UCITS managers and UCITS for inclusion. In addition to the indicators provided by ESMA, for risk-scoring purposes in order to help rank and prioritise the UCITS and UCITS managers subject to Stage 2 investigations, NCAs applied a holistic approach to the identification of the Stage 2 sample. This also considered, not only the Stage 1 information and list of indicators, all additional information gathered in the context of the COVID-19 crisis, including any other supervisory knowledge and information available to them e.g. commercial data, media reports, complaints, whistleblower notifications, with relevance to UCITS liquidity management risks.

8. All 30 EU and EEA NCAs participated in this CSA and shared knowledge and experiences at the level of ESMA throughout 2020, to ensure supervisory convergence in the way they supervise LRM, and ultimately enhance the protection of investors across EU and EEA Member States.

Overall level of liquidity risks and compliance of LRM practices

9. Overall, cases where NCAs identified significant liquidity risks that could jeopardise the capacity of the UCITS under review to meet redemption requests, or to honour their other liabilities were reported to be low. For a very limited number of UCITS, liquidity profiles pointed to potential asset/liability mismatch risks, which were only sometimes mitigated using liquidity management tools (LMTs). In most cases, the exercise found that the level of compliance with the applicable rules on LRM was satisfactory with entities meeting their regulatory obligations. However, the exercise also identified shortcomings in some cases and the need for improvements in certain key areas. Consequently, NCAs are following up with market participants to address the supervisory findings identified in the context of the CSA.

10. This overall positive assessment is broadly consistent with (i) the results of the supervisory monitoring activities of NCAs following the outbreak of the COVID-19 pandemic, and (ii) the conclusion of the work on the implementation of the ESRB recommendation on liquidity risks in corporate and real estate funds.

11. Overall, most UCITS managers have demonstrated that they have implemented and applied sufficiently sound LRM processes. In terms of supervisory findings made with respect to a limited number of market participants as well as considering observed best practices, NCAs reported areas of improvements with regard the following topics:

    i. **Documentation of LRM arrangements, processes and techniques:** In some cases, there was no documentation available or a lack of granularity/clarity was detected in various key areas such as pre-investment liquidity analyses and forecasts, design phase, escalation processes and verification of data reliability despite regulatory obligations requiring that relevant activities should be written and documented;

    ii. **LRM procedures:** Issues with the quality of the written LRM procedures were detected in some cases. For instance, some procedures did not provide for the documentation of the LRM arrangements, processes and techniques or did not cover all asset types or the use of LMTs (from the analysis during the product design phase to their ongoing use, etc.). In a few isolated cases, no written LRM procedures were put in place;

    iii. **Quality of LRM mechanisms and methodology:** in some cases, the methodology was not always appropriate, not forward-looking and, more frequently, not justified and back-tested. For example, insufficient pre-investment checks – measurement of liquidity in pre-investment analyses and forecasts, consideration of portfolio impact, etc. – or ongoing monitoring – absence of analyses involving all liabilities, lack of investors behaviour modelling and forward-looking estimates, verification of data quality, etc. – were observed. In some particularly worrisome cases, margin calls were not considered at all. In some cases, LRM mechanisms and methodology were too static, with, for instance, questions raised on the accuracy of LRM modelling during market downturns – including the accuracy of the data used for modelling the liquidity which should give due consideration to the prevailing market circumstances. This may result in unrealistically stable or even improving liquidity forecasts in crisis time;

    iv. **Overreliance on liquidity presumption with regard to listed securities:** In some cases, UCITS managers placed an overreliance on the presumption of liquidity referred to in Article 2(1) of the UCITS Commission Directive 2007/16/EC (UCITS Eligible Assets Directive) where they invested in listed securities. In addition, without dedicated follow-ups on securities presumed liquid, some ongoing controls were insufficient as they were not based on reliable data on volumes e.g. past volumes, number of brokers and trading size. The mere lack of any data on volumes should be considered as possible evidence of the lack of sufficient liquidity and would need to be further investigated;

v. **Application of liquidity presumption to financial instruments which are not admitted to or dealt in on a regulated market in violation of Article 2(1) of the UCITS Eligible Assets Directive (Commission Directive 2007/16/EC):** NCAs investigations revealed that a few specific supervised entities had applied the presumption of liquidity to all assets, including financial instruments which are not admitted to or dealt in on a regulated market under the conditions set out in Article 50(1) of UCITS Directive 2009/65/EC, where overall portfolio liquidity was deemed sufficient. In these cases, no liquidity analysis and forecasts were performed for investments subject to Article 50(2)(a) of the UCITS Directive 2009/65/EC, which allows for investments in unlisted securities up to a limit of 10%. Performing no pre-investment liquidity analyses and forecasts for these financial instruments is not compliant with the UCITS framework and should therefore be further investigated;

vi. **Delegation:** Some NCAs identified a few cases where the entity to whom the portfolio management function was delegated effectively also performed the LRM functions. Those cases also revealed an insufficient involvement of the internal risk management function, as well as insufficient delegation monitoring and due diligence. Moreover, the simultaneous delegation of portfolio and risk management functions to the delegate should not be allowed as it contravenes UCITS delegation and substance rules;

vii. **Data reliability:** in some cases, NCAs observed a widespread lack of data quality checks in a context of overreliance on very few data providers. In those cases, UCITS managers had not implemented robust and documented control processes, based on cross-checks and back-tests to ensure that they use sound and reliable data as explicitly required by the UCITS Directive;

viii. **Disclosures:** NCAs reported some cases of missing, inaccurate, or unclear disclosures on liquidity risks and LMTs to investors in UCITS KIID and/or prospectus;

ix. **Governance:** In some cases, insufficient (in terms of frequency, granularity and clarity) and, more rarely, absence of reporting to senior management were detected. Some processes raised questions regarding the soundness and documentation of the decision-making process, in particular with regard to escalation process or analyses conducted during the design phase e.g. formalisation of the decisions relating to the design of the UCITS, the set up and calibration of LMTs, procedures for monitoring the actual use of LMTs, lack of documentation of the cases escalated to the board or to senior management and their resolution, and lack of formalisation of the criteria that trigger the escalation process;

x. **Internal control framework:** In some cases, NCAs detected no regular second- and third-level controls of LRM policies and procedures, and identified a strong need to strengthen the overall control framework as both compliance and internal audit functions were not performing sufficient controls with respect to LRM processes. In such cases, these control functions have not been able to detect most of the shortcomings and regulatory breaches identified by NCAs in the course of the CSA; and

xi. **External controls:** External controls by the depositary and external auditors of the UCITS and UCITS managers are not performed in all cases. With respect to controls by external auditors, this might also be explained by diverging national rules and practices regarding the scope of audit.

12. More broadly, the COVID-19 crisis revealed cases of lack of reactivity or adaptation of the LRM assessment i.e. adapting risk analyses and forecasts, understanding of the limits of the models employed to the changed market conditions, etc. and governance e.g. escalation processes, which NCAs will also address in their follow-up supervisory actions.

Convergence measures

13. NCAs are responsible for determining which course of action would be most effective to mitigate the risks identified at the individual and collective level, including the instrument of enforcement after further investigations, where deemed appropriate by NCAs. ESMA observed a high level of convergence in the way NCAs supervised the LRM practices of UCITS and UCITS managers in their respective Member States. Supervisory convergence being a core objective at EU level, ESMA has identified room for further ESMA convergence work with respect to NCAs follow-up actions, including enforcement actions where appropriate.

14. It was therefore agreed that further work will be carried out at the level of ESMA to promote further convergence in the way NCAs follow-up on the supervisory findings made during the CSA. ESMA will also consider whether the results of CSA should lead to any follow-up policy work.

Next steps

15. Market participants should critically review their LRM frameworks to ensure that none of the adverse supervisory findings referred to above are to be found in their LRM frameworks. Market participants should also ensure compliance with all relevant UCITS regulatory requirements and associated EU and national guidance at all times.

16. Furthermore, NCAs will undertake follow-up actions on individual cases to ensure that regulatory breaches as well as other shortcomings or weaknesses identified are remedied, especially regarding the key findings referred to in paragraph 11 above. Some NCAs have also indicated that they need to further interact with some UCITS managers, through on-site visits and/or desk-based reviews of the latest documents provided, to

complete their supervisory analysis. Stringent supervision of the existing UCITS regulatory requirements is key to prevent regulatory breaches and deficiencies that may undermine investor confidence in the UCITS product and EU/EEA capital markets.

17. The CSA results should be read in conjunction with the result of the implementation of the ESRB recommendation on liquidity risks in investment funds[5], which defined five priority areas for consideration.

[5] Report on ESRB recommendations on liquidity risks.