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ESMA Guidelines on Liquidity Stress Testing

The European Securities and Markets Authority ("**ESMA**") has published new guidance on liquidity stress testing by UCITS and alternative investment funds ("**AIFs**").

On 2 September 2019, ESMA published a **final report** containing guidelines on liquidity stress testing in UCITS and AIFs. ESMA states that the guidelines are supplementary to the requirements on liquidity stress testing which are set out in the AIFMD and UCITS Directive and are already applicable.

The report contains an overview of the feedback ESMA received to its February 2019 consultation on draft guidelines and ESMA's response.

The guidelines (set out in Annex III) apply to fund managers, depositaries and NCAs. They aim to increase the standard, consistency and frequency of liquidity stress testing (referred to as LST) already undertaken and promote convergent supervision by NCAs. The principle of proportionality applies and the guidelines should be adapted to the nature, scale and complexity of a fund. LST should be documented in an LST policy within the UCITS and AIF risk management process, which should require the manager to periodically review and adapt, if necessary, the LST as appropriate.

The guidelines require managers to build LST models and have a strong understanding of liquidity risks and a fund's overall liquidity profile. LST should be properly integrated and embedded into a fund's risk management framework and subject to appropriate governance and oversight. Specifically, the guidelines set out what needs to be documented in an LST policy and how frequently testing should occur. ESMA recommends that managers employ quarterly or more frequent LST.

When developing new funds, managers applying for authorisation will have to demonstrate that a fund will remain sufficiently liquid during normal and stressed circumstances. This includes redemption requests by investors which are, according to ESMA, the most common and important source of liquidity risk and could also impact financial stability.

Stress testing should enable a manager to assess both fund assets and liabilities and their effect on fund liquidity. Managers are also expected to aggregate LST across funds under management to better ascertain the liquidation cost or time to liquidity of each security.

Depositaries need to have appropriate verification procedures to check that fund managers have in place documented LST procedures.

With regard to money market funds ("**MMFs**"), these already fall under the Money Market Funds Regulation ("**MMFR**") and ESMA's Guidelines on Stress Testing Scenarios under the MMFR, which include more stringent provisions adjusted to the specificities of MMFs in terms of liquidity. ESMA has taken on board feedback to its consultation and decided to narrow the scope of applicable provisions to MMFs, focusing on those parts of the guidelines not already covered in the MMFR rules. In the event of a conflict between the guidelines and the MMFR rules, the MMFR rules apply.

The guidelines need to be translated, which will trigger a two-month period during which NCAs must notify ESMA whether they comply or intend to comply with the guidelines. The guidelines apply from **30 September 2020**.

Please get in touch with your usual Asset Management and Investment Funds Department contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this update.

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