

Robeco response to ESMA consultation on Guidelines on liquidity stress testing in UCITS and AIFs¹

INTRODUCTION

Robeco welcomes ESMA's intent to publish guidelines on liquidity stress testing in UCITS and AIFs. Robeco has long been a promotor of industry wide solutions for impending liquidity risk concerns and has pushed for a better understanding of liquidity risk and consensus on what is an effective liquidity risk management framework for investment funds. To this latter aim Robeco has published a white paper in October 2018 titled "Liquidity risk management for investment funds: towards an effective framework"². This white paper describes Robeco's liquidity risk management framework and the essential role that liquidity risk monitoring (i.e. liquidity stress testing) plays in this framework.

One of the key elements in understanding liquidity risk and liquidity stress testing is that neither is meaningful without the notion that liquidity risk only materializes when funding liquidity (i.e. liquidity demand) exceeds asset liquidity (i.e. liquidity supply). Asset liquidity, in turn, is best understood as three-dimensional. The dimensions being: time, transaction size and transaction cost. Asset liquidity calculations or scenarios should start with considering the appropriate timeframe, the maximum acceptable transaction cost and the appropriate liquidation scenario (e.g. waterfall or pro-rata). Funding liquidity risk may have several sources, but is most prominent in case of large redemptions. It is the combination of normal and stressed asset liquidity calculations and redemption scenarios that shapes meaningful liquidity stress testing in an adequate liquidity risk management framework³.

Please find below our response to a selection of your questions posed in the consultation paper.

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?

We would suggest narrowing the scope to those fund where, due to the nature and structure of an event, liquidity risk could possibly materialize. This means that closed ended funds, which cannot be faced with intermediate redemption requests, should be excluded.

In the same spirit, we do not support ESMA's statement on paragraph 21 (page 11) that "liquidity risk may materialize independently of redemptions." A fundamental feature of a liquidity risk is the occurrence of redemptions (which cannot be sufficiently mirrored by the sale of fund assets in a timely and cost-efficient manner). The redemptions element is already rightly included in ESMA's own definition of liquidity risk on page 21 of the CP.

Despite being related, it is important to distinct fund liquidity risk from market risk. Closed ended funds that are listed on a stock exchange and which are traded in the secondary market may suffer from large price movements (market risk) as investors sell their shares below the intrinsic value of the fund as a result of lower liquidity in the secondary market. This is an active choice of a an investor, transparent to the investor and beyond the control of the fund manager so to our opinion should be out of scope or requires a different approach.

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² <https://www.robeco.com/en/insights/2018/10/what-you-should-know-about-liquidity-risk-management.html>

³ See also Bouveret, A., 2017, IMF Working Paper, *Liquidity Stress Tests for Investment Funds: A Practical Guide*, available via: <https://www.imf.org/en/Publications/WP/Issues/2017/10/31/Liquidity-Stress-Tests-for-Investment-Funds-A-Practical-Guide-45332>

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?

We welcome principle-based approach that goes with the ‘nature, scale and complexity’ element. It allows the managers the flexibility to tailor frequency and granularity of LST appropriate to the strategy of the fund.

In relation to prescriptive reporting requirements laid out under AIFMD and additional reporting requirements by some NCAs for funds in the UCITS regime, we would welcome additional clarity on the definitions of ‘time to liquidity’ and ‘liquidity buckets’ (paragraph 26, page 32) to enable investors to better compare fund liquidity calculations between managers of funds with similar strategies. For now, the existing definitions leave too much room for interpretation (e.g. with regard to acceptable transaction cost) to allow for such comparison.

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?

We believe that managers should have at least 6 months after the final publication of the guidelines to operationalize the new requirements.

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?

We generally agree with the overall approach of a list of Guidelines that all managers should take into account as a matter of soft law. Including some of the explanatory considerations in the final guidelines might be helpful.

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

Guideline 2: We concur with ESMA that LST should be embedded in and based on a policy. However, we do not see merit in adopting a *separate* LST policy document on top of the already mandatory risk management policies under AIFMD and the UCITS Directive. LST is useful but only one of several tools within the wider liquidity risk management framework and should, thus, be assessed and used in alignment with the other components of the framework. Hence, an overall risk management policy in which provisions on LST are included makes better sense.

Guideline 5: We would question proposed paragraph d which states that: “LST should provide outcomes which can be used to: [...] Assist risk management monitoring and decision-making, including setting relevant limits regarding fund liquidity.”

In our view there is no uniform approach to set fund liquidity limits. Liquidity modelling is highly dependent on the underlying portfolio, available data, assumptions on the practical ability to sell assets and market liquidity. LST should be regarded as a useful tool to collect information to identify potential problems and possible opportunities for risk reduction.

Guideline 8: We are concerned about the proposed requirement on reverse stress testing. As stated in our introductory note, liquidity stress testing can only be meaningful if it combines asset and funding liquidity. Combining asset and funding liquidity requires assumptions (i.e. scenarios) for both asset side (e.g. timeframe, transaction cost or liquidation scenario) and funding side (e.g. level of redemptions). Your definition of reverse stress testing states: “a fund-level stress test which starts from the identification of the pre-defined outcome with regards to fund liquidity (e.g. the point at which the fund would no longer be liquid enough to honour requests to redeem units)”. The point here is that if you have determined that pre-defined outcome, the point at which the fund would no longer be liquid enough to honour requests to redeem units, you already have defined a scenario, namely the level of asset liquidity within certain market liquidity conditions, within a certain timeframe, against a certain transaction cost via a certain liquidation scenario. As such, we believe the use of the term “reverse stress testing” is at least not appropriate in this context and at worst confusing.

Guideline 9: We understand and agree that managers should be able to overcome limitations related to the availability of data. To meet their data needs it is market practice for managers to use third party data providers. Adequate liquidity risk management is served when a manager uses data of a highly esteemed data service provider (e.g. ITG, IHS-Markit or MSCI) to perform LST. It would be disproportional to expect managers to put in place and run burdensome validation models in relation to these third party data providers.

Guideline 10: We agree with the proposed guidelines, which reflects that ESMA realizes that it can be complicated. In particular paragraph d can be pretty challenging and involve the application of multiple algorithms, variables to calculate liquidity profile etc. More broad based principles could be considered that would cover paragraphs a-d: such as a fair treatment of all shareholders such as polluter pays principle (and its implications for the maximum acceptable transaction cost) and limited distortion of the portfolio after liquidation (to guarantee preservation of the risk profile).

Guidelines 11: We agree with the guideline.

Guidelines 12: We agree with the guideline.

Guidelines 13: We agree with the guideline.

Guidelines 14: We agree that managers should be expected to aggregate their LST where appropriate to funds. This could be the case if a manager manages multiple funds with similar strategies or exposures. Aggregating LST of funds with deviating strategies is useless and complicated to proceed.

Guidelines 15: We agree with the proposal for depositaries to carry out their duties regarding LST and that it should be part of the depositary review of the UCITS/AIF RMP involved.

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

We would like to point out that most of the parameters listed under item 28 (page 32-33) with regard to historical scenarios are not necessarily asset liquidity parameters. These parameters (e.g. material increase of interest rates) are drivers of market volatility and not necessarily, market liquidity. More in general market volatility does not necessarily coincide with market illiquidity (the relationship is sometimes even inverse, for instance after the Brexit vote volatility rose while trading volumes multiplied). More appropriate liquidity parameters would be trading volumes, bid-ask spreads or market depth (i.e. the total capacity of the market in a specific instrument).

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

See our remarks under question 6 with regard to guideline 8.

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 appreciate ESMA's effort to sensibly reflect the complexity of the asset liquidation method. We prefer to use the term "limited distortion of portfolio after liquidation". The level of distortion acceptable is dependent on the level of liquidity demand/funding liquidity. The higher the level of redemptions the lower the level of distortion (the closer to a pro-rata/vertical slice liquidation) should be (as the effect of the remaining investors increases with the size of the redemption).

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

We agree with ESMA wording in paragraph 36-37 (page 35). The concept is contentious and complicated to apply. In practice price spirals are already part of 'fire sale' assessments carried out by managers as part of LST and the appropriate action in such an event is integral part of the manager's contingency planning.

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

See our remarks under question 6 with regard to guideline 8. Meaningful liquidity stress testing can only be done by taking the combination of asset and funding liquidity into consideration.

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

We strongly agree with this guideline. This is the only meaningful approach to liquidity stress testing.

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

We concur with ESMA (item 59 and 60, page 46) that there is added value in liquidity stress testing in the product development stage. We do like to point out that this would require an additional layer of assumptions which could potentially negate the added value. For normal liquidity stress testing the composition of the asset (portfolio) and liability side (shareholders) of the balance sheet as well as the size of the balance sheet (AuM) are given. In the product development stage one would have to make assumptions about the composition and the size of the balance sheet, making results of the LST more difficult to assess.
