

29 March 2019

ESMA
CS 60747 – 103 rue de Grenelle
75345 Paris Cedex 07
France

Submitted online at www.esma.europa.eu

RE: Guidelines on liquidity stress testing in UCITS and AIFs

Dear Sirs,

BlackRock¹ is pleased to have the opportunity to respond to the Consultation Paper on Guidelines on liquidity stress testing in UCITS and AIFs, issued by ESMA

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to comment on the issues raised by this Consultation paper and will continue to contribute to the thinking of ESMA on any issues that may assist in the final outcome.

We welcome further discussion on any of the points that we have raised.

Yours faithfully,

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¹ BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

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Executive summary

The 2008 financial crisis taught us that even things that have never happened historically can occur in the future. This means that history does not contain the universe of all possible future events. On the other hand, it is not possible or practical to have contingencies in place for every possible future outcome, particularly in light of resource limitations and the magnitude of the exercise to calculate all outcomes. Therefore, effective risk management requires grounding in the practical with an awareness that things that have never happened before can and do happen. As such, judgment and prudence are required when setting risk management policies and parameters.

Because the “price” and NAV of an investment can and do adjust to reflect market prices, fund investors bear the risk of market fluctuations and the market impact arising from the asset sales required to meet fund redemptions. We have observed this “market clearing” effect and related price movements across many market cycles, including the 2008 financial crisis. Investment funds are, by design, financially robust enough to “pay” the cost of market liquidity in almost any conceivable environment. Unlike banks, which have an obligation to meet liabilities (including the repayment of the principal of their depositors), fund redemptions are executed based upon a pro rata share of the value of the securities held in the fund, with no guarantee of a particular price. These important differences must be considered when applying liquidity stress testing for investment funds.

Liquidity and redemption risk management is an integral part of portfolio management. This is not a new phenomenon and asset managers have been performing liquidity and redemption risk management for a very long time. Portfolio managers use their judgement to properly reconfigure their portfolios to changing circumstances. Structural fund flexibility provides portfolio managers with an enhanced “toolkit” to manage liquidity “tail” risk and atypical redemption events.

Liquidity risk stress testing simply cannot be done with the intellectual and quantitative rigour and standardisation of approach that one might ideally want. Precision on any liquidity stress test must be qualified based on the availability of market data and the inherent limitations of historical observations to predict future investor behaviour. That said, while BlackRock currently performs the regulatory-required liquidity stress tests, BlackRock has also been managing liquidity and redemption risk in funds for almost thirty years and has established an approach and framework that combines portfolio manager experience and judgement, quantitative analysis and qualitative elements such as market and product knowledge.

Overarching Concepts Relating to Fund Stress Testing

Our ability to understand what future adjustment processes for market prices (which vary by the time needed to liquidate and trade size) would be in stressed market conditions is necessarily limited based on: (i) what has actually happened historically; and (ii) available data to analyse price behaviour, as this data is either incomplete or limited to small quantities of traded amounts during normal markets

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versus large quantities in disrupted markets, which makes it difficult to infer all outcomes that are possible.

As such, there is no substitute for informed judgement, such as what a trader in a market can provide from a qualitative perspective, which can be supplemented by data and predictive models. Markets may not always be able to provide unlimited immediacy for transactions. Sometimes certain markets may not clear due to market failures – as we saw in the crisis.² In other cases, the market impact of transacting might be so severe as to make it too costly to transact. In yet other cases, markets may not be available or open.

While the practice of liquidity stress testing has many intrinsic limitations, we believe promulgating common standards and best practices for liquidity risk management including liquidity stress testing for individual funds, ensuring risk management functions are independent from portfolio management, and an enhanced fund structural “toolkit” will be much more effective than other solutions that have been proposed to address potential scenarios where there are large redemptions from mutual funds.

Importantly, at this time, there is no single risk measure that we can use to draw definitive conclusions about the liquidity and redemption risk in a given fund. As such, risk managers review the metrics on the liquidity risk dashboard holistically in order to draw conclusions about the adequacy of a fund’s liquidity. Risk metrics in the liquidity risk dashboard are used along with a broader analysis of overall market liquidity, fund and sector returns, historical and forecasted redemptions (including during adverse market conditions), and available liquidity sources such as short-term borrowing capacity.

We are strong supporters of the work carried out by EFAMA and the ICMA Asset Management and Investors Council (AMIC) in this areas and draw ESMA’s attention to the recommendations made in the joint report issued by these two organisations on [liquidity stress testing](#) on 8 January 2019.

In our response we also suggest alternative approaches to the application of the proposed rules to certain fund types such as ETFs which have a very different liability structure to standard mutual funds, to money market funds which are already subject to detailed liquidity stress testing rules and to funds investing in illiquid assets, especially where the fund is of a closed-ended nature.

² See Bennett W. Golub and Conun Crum, *Risk Management Lessons Worth Remembering from the Credit Crisis of 2007-2009*, 36(3) *Journal of Portfolio Management* 21-44 (Spring 2010).

Response form for the Consultation Paper on the Guidelines on liquidity stress testing in UCITS and AIFs

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.

Additional costs are likely to be incurred by complying with the proposed guidelines. These are likely to be incurred as a result of designing additional systems and accessing additional data points which are not necessarily easily obtainable. Certain tests such as reverse stress testing are currently conducted on an ad hoc and qualitative basis and are tailored to the requirements of specific funds. If these tests are made mandatory we will need to move from a manual to an automated process which will take significant development time and resources to implement. Similar criteria apply to the application of stress testing of “other liabilities”.

The potential requirement to validate all assumptions, as with a model portfolio, is likely to incur significant additional costs.

The more detailed the requirements are the higher implementation costs are likely to be. Given the time needed to build and ensure effective implementation we recommend an implementation period of 18 months to deliver all the changes which are potentially required,

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 support the application of the guidelines to both UCITS and AIFs provided firms can apply the requirements in a proportionate way and adopt the rule to the different types of fund strategies. In particular certain types of strategy of fund structure require a different set of tools or focus.

By way of example, please see our response in respect of the considerations which need to be applied to funds investing in illiquid assets and in respect of ETFs in Question 13 below.

We note that many of the metrics addressed in the Consultation are not relevant to ETFs because of the different liability profile inherent in the ETF structure and consequently ETFs should retain the ability to choose more appropriate metrics to manage their liquidity. For example, the underlying liquidity of the investments may be applied in a “reverse stress test” scenario, where deemed necessary.

Given the comprehensive nature of LST applicable to money market funds there seems to be little additional value to include MMFs in the scope of these Guidelines. We would recommend an approach where MMFs following the MMFR specific liquidity stress testing rules are deemed to comply with these Guidelines

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unless specific additional requirements are highlighted= by way of exception. This would avoid the risk of complying with counterproductive and potentially duplicative regulation. It would also minimise the risk of divergence inherent in applying two separate set of Guidelines in the future.

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 the proportionate approach inherent in the reference to the ‘nature, scale and complexity’ of a fund. We would welcome confirmation that it is possible for the investment manager to determine the relevant stress tests for specific funds based on the fund’s investment strategy, risk profile and the inherent liquidity risk (including structure and investor base).

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 recommend an implementation period of 18 months given the complexity of operationalising the full requirements of the Guidelines across a wide variety of funds, strategies and liquidity profiles.

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?

In general, we agree with this approach. The explanatory guidelines would help to limit the room for interpretation and divergences between minimum standards. However, sufficient flexibility should be given to managers to determine the internal standards for liquidity stress testing activities for various funds.

We note that Guideline 5(d) implies that the funds should set limits regarding fund liquidity. We do not agree with the setting of rigid limits on liquidity and the wording in Guideline 5(d) appears to see the setting of limits as mandatory given the changing nature of liquidity over time. Management companies should rather have regard to the redemption commitments of the relevant fund and the requirements of investors and be encouraged to set the types of limits or flags they believe to be appropriate for their fund.

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

We set out a number of suggested changes to the Guidelines in our subsequent responses in particular in relation to reverse stress testing, model validation, liability assessment and data availability and the level of proportionality which needs to be applied to different types of fund structures and strategies.

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

As noted above, the explanatory considerations are a useful tool in driving the consistent adoption of LST standards across jurisdictions and managers.

One of key challenges managers face on data availability is the lack of information regarding underlying investors from distributors and fund platforms. We believe that ESMA could engage with major transfer agents and fund registrars to identify what additional data could be provided to managers without driving significant additional costs. Managers by and large do not require individual investor data but rather an indication of investor type which often represents a good indicator of the likelihood of investors redeeming (for example whether underlying clients are retail or professional clients, tax incentivised or discretionary clients).

We highlight that including a process to verify that the fund remains in compliance with the fund objectives and investment policy within the framework of LST is not easily scalable and difficult to automate.

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

Reverse stress testing is inherently a bespoke process. As such it should be required only “where appropriate”, for example, for funds with high liquidity risk or in special circumstances. This qualification would recognise the need for an individual approach to each fund and the consequent complexity of automating reverse stress testing across a wide range of funds.

We also recommend that managers consider, where appropriate, additional aspects as applying fund specific considerations where funds engage in investment strategies exposing them to low-probability risks with a potentially high impact. We would avoid including investment constraints in LST as it both cyclical and cumbersome to implement.

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?

It should remain the primary responsibility of the manager to assess existing data and adapt its LST to the particular circumstances of the fund. Given the variability of data availability we would welcome a more nuanced approach to validating all the assumptions, especially in relation to the expert estimates, as these potentially can result in significant additional cost.

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?

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The recommendation that LST models should reflect how a manager would and does liquidate assets during normal and stressed conditions is problematic. It is not always possible to use methods of liquidating assets which “Accurately reflect how a manager would liquidate assets during normal and stressed conditions in accordance with the applicable rule.” In practice, depending on the relevant market conditions both waterfall” and pro-rata” methods might be considered to be relevant for a fund in different circumstances. An alternative might be for managers to disclose that they may use either methods before deciding which is more appropriate for a specific liquidity event.

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

We welcome the acknowledgement that second round effects such as price spirals are a hypothesis and in particular require a more detailed understanding of how other asset owners will react to market liquidity events and the speed at which they will step in when they ascertain a buying opportunity. The usefulness of including such a hypothesis will depend very much on the availability of wider market data needed to validate and justify any such hypotheses.

Second round effects are therefore difficult to model and are more likely to consider them in liquidity contingency planning. As mentioned above the requirement that a manager should accurately reflect how it would liquidate assets during normal and stressed conditions is often not achievable in practice.

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?

When considering relevant inputs into LST models we agree that price uncertainty is an important aspect closely related to other LST factors such as transaction costs (market impact) and liquidation period. We would not recommend considering it as a separate factor in the LST, but rather include price uncertainty indirectly as one of number of parameters included within liquidity modelling. Price uncertainty is a factor to be considered in a manager’s contingency planning and when deciding to use additional liquidity management tools such as swing pricing, where available to the manager.

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?

One of the key elements in LST for funds investing in less liquid assets is the structure of the funds itself and whether the dealing cycle reflects the underlying liquidity of the assets in the fund. This is a broader questions relating to the manager’s own product development and liquidity management processes.

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Establishing LST for funds invested in less liquid assets would require even more thorough analysis and consideration than for liquid funds due to the very fund-specific nature of liabilities that they may have. Given the highly heterogeneous nature of structures and underlying asset base for these types of funds it is essential that managers retain the ability to assess on case by case basis how relevant the various considerations ESMA has put forward to individual funds and strategies. We emphasise the importance of putting comprehensive contingency plans in place for these funds.

The requirement of reverse stress testing for less liquid funds raises the same concerns as we raised in our response to question 8.

We believe ESMA should acknowledge the roles Authorised Participants' and other liquidity providers play as providers of liquidity when considering how to apply LST to ETF structures. Appropriate consideration should be given to the testing of an ETF's underlying asset market in the product's pre-launch phase, particularly as direct redemptions can only be performed by an Authorised Participant (AP) and are generally settled in-kind. This means that managers are generally not required to make the type of cash sales required for typical open-ended investment funds. Investors in ETFs access liquidity by trading their shares on very liquid secondary markets. These considerations require managers to adapt liquidity measures to the specifics of the ETF product wrapper. It is important not to focus excessively on the direct redemption process rather than focussing on whether the standard arbitrage mechanism with the APs is operating as efficiently as possible.

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 recommend managers consider "other liabilities" described within the section. We believe that these liabilities need to be considered only if they have a material impact on the fund's liquidity. These liabilities are will have often been identified already in the fund's risk profile set at launch.

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 may make sense to look at different types of liabilities separately. For example borrowings could be treated as an additional "other type of liability".

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

Please see our comments in response to Question 8. As mentioned reverse stress testing could be beneficial for some funds where automation is achievable, for example, the reverse stress testing which is required to be performed for MMFs. We

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believe managers should have a discretion to apply the reverse stress testing depending on the risk profile of the fund.

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?

Including analysis of investor behaviour is only feasible where managers have access to relevant information on the fund’s end client base, and transaction history. We recommend qualifying the relevant Guidelines with a statement such as *where available* to recognise the data availability issues managers face where data is not always available or reliable. ESMA and NCAs could usefully encourage the disclosure of underlying client data by type and channel. Assumptions in relation to investor behaviour are therefore difficult to validate and unless they are sufficiently detailed may be of limited value, and in the absence of a pan-industry solution would require significant implementation and maintenance costs.

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

We agree with this approach.

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

We see limited value in aggregating LST across funds. The aggregation of stress testing results at the asset class level, investment fund level and/or on client group/client level is unlikely to deliver useful information. Most funds are set up as separate legal structures managed in different ways and for different investor bases meaning there is no interconnectedness across funds or management structure. In particular, as separate legal entities the manager does not have recourse to the assets of one fund to meet the liabilities of another fund. Even if a management company-wide view can be put in place, the decision on the exact set-up for individual funds should remain with the relevant fund manager. It is also important to recall that liquidity (liquidity risks) can only be assessed and managed at the individual fund level, not at the level of the management company. This is because the assets and liabilities of a fund are managed at the fund level and it would be difficult to achieve considering the differences between the funds. The only example where aggregation might be considered useful is where it covers similar products managed by the same portfolio manager for determining the capacity of a common strategy housed within different fund wrappers.

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

For the reasons set out in our response to Question 19 we do not apply this process.

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

We agree LST can be used various stages in the lifecycle of a fund but needs to be applied in a proportionate way. For example the application of LST at the pre-launch stage involves various critical assumptions such as target portfolio size and the target investor base. The application of quantitative LST will at this stage be of limited use. The qualitative assessment of liquidity risk, however, is very important at this stage. In addition consideration should be given to the availability/applicability of additional liquidity management tools and develop appropriate contingency plans.

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

We see limited value in the use of LST in determining the appropriate investments of a fund. Typically, the appropriate investments are driven by other considerations such as the fund's investment policy, the investment restrictions and the investor profile.

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

We believe that the major use cases of LST are sufficiently described.

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. LST could be performed more often if appropriate to the nature of the fund (for example, for funds with daily redemptions, funds with high liquidity risks) or where warranted by specific circumstances. In addition managers will frequently conduct broader portfolio liquidity analyses.

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

We believe that these circumstances should be defined by managers themselves given the wide universe of funds and strategies in the market.

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

LST can be performed on ad hoc basis in cases of an emerging/imminent risk and if deemed practicable by the manager. There may be cases in a stressed situation where it is more appropriate to move immediately to use liquidity management

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tools rather than apply additional LST. We believe that more focus should be given to developing an appropriate contingency planning and to focus on the 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 programme.

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

The overall LST framework should be described in the RMP. We believe that the information described within point 69 (see below) could usefully be included in the RMP.

- The funds on which LST is undertaken (scope)
- The types of scenarios used
- The frequency of LST
- Frequency of review of the LST policy

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?

The UCITS and AIFMD delegation rules requires managers to exercise appropriate oversight over delegated service providers with the ability to access relevant information from their delegated providers. In addition to information provided by their delegates we believe that managers can use the data provided by independent functions such as trading departments and external parties in their analysis.

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

We generally agree with the proposed Guideline for depositaries.

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

In our experience, depositaries as part of their ongoing due diligence process request copies of the UCITS RMP and AIF RMP on a regular, generally annual, basis.

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?

Managers should retain sufficient flexibility in the design and application of LST. It would be a difficult process to capture the variability of LST in a single reporting format. It may be helpful to recommend a common framework of reporting LST in

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order to promote consistency across different jurisdictions and managers provided that it remains flexible and can adapted to different types of funds.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by the Consultation Paper and will continue to work with ESMA on any specific issues which may assist it.