ALTERNATIVE CREDIT COUNCIL
LENDING FOR GROWTH

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Dear Sirs,

AIMA and ACC response to ESMA's consultation paper on liquidity stress testing in UCITS and AIFs

The Alternative Investment Management Association Limited (AIMA)[1] and the Alternative Credit Council (ACC)[2] welcome the opportunity to provide feedback in response to the questions posed by the European Securities and Markets Authority (ESMA) in its consultation paper on liquidity stress testing in UCITS and AIFs (the 'Consultation Paper').

AIMA and ACC members welcome the intention to publish principles-based guidelines which would avoid a "one size fits all" approach that could be counterproductive in terms of effective risk management. Since the universe of AIFs and UCITS funds is very heterogeneous, we believe that a good balance must be maintained between consistency among market players and the ability for a manager to tailor its liquidity stress tests ('LST') to its strategy.

In addition, it is imperative that LST be considered in conjunction with the investors' liquidity profile, the redemption periods and other liquidity management tools in place, such as lock ups

[1] AIMA the Alternative Investment Management Association, is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $2 trillion in assets.

[2] The ACC is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 140 members that manage over $450bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy, providing finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts, and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

or gates. As far as our membership is concerned, most alternative investment funds ('AIFs') have infrequent redemption periods and have other liquidity management tools in place, in contrast to the average UCITS fund with daily redemption rights and limited liquidity risk management tools. LST on potential "illiquid assets" held by closed-end funds should also be performed taking into account the redemption periods for closed-end funds which can be infrequent, or even non-existent.

Our members also invest in highly heterogeneous strategies, some of them being focused on securities traded on markets, other on private assets, commodities or derivatives. Any published guidelines need to be flexible enough to be valuable for any kind of strategy and overly prescriptive approaches may significantly diminish the value of the exercise in many cases. Since most of our members already conduct LST as required by the AIFMD and the "Annex IV" reporting, we would also recommend avoiding imposing additional tests or disclosures compared to what is already required. We would rather recommend such guidelines to remain focused on the methodologies of existing LST, rather than trying to impose new ones.

LST is one risk management tool among many used to inform the risk management team. Depending on the circumstances, some approaches will be more useful than others. Maintaining high-level guidelines would enable fund managers to choose the most efficient and relevant scenario or ratio, in line with applicable – and constantly changing - circumstances. The guidelines should therefore remain more indicative with illustrative examples, rather than strict requirements.

Having rigid and prescriptive LST requirements could result in firms managing to the requirements by avoiding the same types of scenarios or outcomes that result in a poor LST result and could contribute to reinforcing herd behaviour with negative effects in terms of financial stability and systemic risks.

For the reasons mentioned above, and as further detailed in the Annex, we strongly welcome the intention of ESMA to avoid a uniform approach to LST guidelines. Although ESMA has stated its intention for these guidelines to remain principle-based and high-level in the Consultation Paper, we believe that some of the guidelines, as well as some of the "explanatory considerations" detailed in the Consultation Paper, could be interpreted in a prescriptive way. In the Annex we have indicated a number of instances where we would welcome additional flexibility.

We would be happy to elaborate further on any of the points raised in this letter. For further information please contact Jennifer Wood, Global Head of Asset Management Regulation & Sound Practices (jwood@aima.org).

Yours sincerely,

Jiří Król
Deputy CEO
Global Head of Government Affairs

ANNEX

There are a number of specific questions posed in the Consultation Paper. We have included the answers to some of these below listed in the order the questions appeared in the discussion paper. Where we had no comments on a particular question, we have omitted that question from the list below for brevity.

Scope

Q1 What additional costs and benefits would compliance with the proposed Guidelines bring to the stakeholders you represent? Please provide quantitative figures, where available.

Although most of the AIFs and UCITS fund managers already apply most of the processes that are suggested in the Consultation Paper, some do not apply these concomitantly or at the level of frequency required, especially in the universe of UCITS funds. For these firms, there will be some IT build needed in all of the different systems and at the level of different funds, which will result in 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?

AIFs are already required to conduct and report on LST as part of their AIFMD Annex IV reports (which have to be filed quarterly, bi-annually or annually depending on the size of the AIFM). We would caution against imposing additional, duplicative requirements.

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?

As regards the scope, we believe these guidelines should be in any circumstances "adapted to the nature, scale and complexity of the fund". Therefore, the term "where relevant" at the beginning of the sentence in Section 2.3(d) should be replaced by "*In all cases*, these Guidelines should be adapted to the nature, scale and complexity of the fund". Indeed, a liquidity stress test is a tool to inform the risk management team of a fund manager and needs to be purposefully crafted, taking into account the specific investment strategy of a fund, as well as other existing liquidity management tools such as investors' redemption processes or cash management. By definition, each investment strategy and each fund's investors are different. Stress tests have to follow very closely the specific features of a fund in order to be useful. Adding requirements that are too prescriptive and that do not take into account the nature, scale and complexity of a given fund at all times might result in stress tests being disconnected from the reality of the liquidity risk of relevant fund. It is therefore crucial that ESMA guidelines remain indicative to ensure that the stress tests conducted are closely tailored to the strategy and liquidity requirements of each fund.

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?

As mentioned above, for some asset managers, especially with respect to UCITS funds, new IT systems will need to be built for each fund managed. This will require a lot of effort and time and it is important that enough time is granted for the implementation of such systems, so as to allow a smooth set up and incorporation of those new requirements into the various risk management programmes. We would therefore recommend a timeline of application of minimum 18 months.

Guidelines on Liquidity Stress Testing in UCITS and AIFs

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 support the objective of improving effective liquidity management practices and we note the desire to ensure a "uniform and consistent application of Union law". We believe, however, that there is a balance to be maintained between harmonization and effectiveness. Too strong a focus on harmonisation runs the risk of high compliance costs for no real added benefit since the resulting standardisation of rules might be disconnected from the reality and therefore will not contribute to improving risk management capacities.

We therefore welcome any mention of avoiding any "one size fits all exercise" as well as reminders that liquidity stress tests are not an exercise to be taken in isolation. We also welcome having a list of high-level guidelines, to be referred to as the minimum standards recommended, which can then be complemented by explanatory considerations. We would, however, recommend that the explanatory considerations remain illustrative, rather than prescriptive, in order to better cater for the heterogeneity of strategies and investors.

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

We believe that for a tool which is one element of a "suite of many tools to manage fund liquidity", as recalled in the point 13 of the introduction of the Consultation Paper, 15 guidelines appear to be quite a long list, especially as it seems that some guidelines could be merged.

We also view these guidelines as a set of indicative elements informing a course of behaviour but we are concerned that a number of areas could be read in a restrictive way depending on the interpretation of the competent authority, hence some of the suggestions made below aiming at a more high-level approach.

Guidelines 1 and 2 are both related to governance and could potentially be merged along the following suggestion:

> LST should be properly integrated, **documented** and embedded into the fund's risk management framework **and procedures** supporting its liquidity management. It should be subject to appropriate governance and oversight**,** including being subject

to **periodic reviews and adaption and to** appropriate reporting and escalation procedures.

We would also add, in Guideline 1, the overarching principle that "LST should be appropriately designed and performed according to the nature, scale and complexity of the fund".

Guidelines 5 and 6 are related to the use that can be made of these guidelines and could also be merged:

> LST should **assist a manager in preparing a fund for a crisis and** provide outcomes which can be used to:
>
> a. Help ensure the fund is sufficiently liquid, as required by applicable rules and redemption terms stipulated in fund documentation.
> b. Strengthen the ability of managers to manage fund liquidity in the best interests of investors, including in planning for periods of heightened liquidity risk.
> c. Help identify potential weaknesses of an investment strategy, and assist in investment decision making.
> d. Assist risk management monitoring and decision-making, including setting relevant limits regarding fund liquidity. This may include ensuring the results of LST can be measured through a comparable metric, such as a key risk indicator.

Guideline 8 is too prescriptive and is redundant with Guideline 7(a) which recommends that the fund manager adapt the "types of scenarios employed to create stressed conditions, which should always be sufficiently severe, but plausible". Guideline 8 should therefore be deleted and moved to explanatory considerations as the various types of scenarios (hypothetical, historical and reverse-stress testing) should be considered as illustrative examples.

Guideline 9 should be reduced to a principle-based recommendation as the demonstration that the manager is able to overcome limitations related to the availability of data is self-explanatory. Points (a)-(c) of Guideline 9 should be moved to explanatory considerations as illustrative examples.

Guidelines 11 and 12 relating to the liability side of the balance sheet could be merged.

> LST should incorporate scenarios relating to the liabilities of the fund, including, **where applicable,** both redemptions and other types of potential sources of risk to liquidity emanating from the liability side of the fund balance sheet, **as well as risk related to investor type and concentration**.

As regards Guideline 14, our members question the usefulness of an aggregated number at the level of the asset manager, the purpose of such a number and how it could be used. We recommend moving this recommendation to the explanatory considerations section where it would be considered as an illustrative possibility accompanied by more substance as to the potential usefulness of such a number.

Finally, we believe that Guideline 15 is redundant with the Level 2 text, in particular with Article 92(2) of the AIFMD delegated regulation 231/2013, which already requires that depositaries "perform ex-post controls and verifications of processes and procedures that are under the responsibility of the AIFM, the AIF or an appointed third party". Adding a specific Guideline related to depositaries' responsibility might be viewed as a distinct and additional feature to what is already required under Article 92(2) and might incur an increase in the cost of depositaries' services. We would recommend deleting this Guideline.

In total we would therefore recommend a maximum of 10 principle-based Guidelines in order for the paper to be efficient, workable and reach its overall objective of assisting AIFs and UCITS managers in their liquidity management, without creating unnecessary costs or paperwork which are in general detrimental to an internal comprehensive and sophisticated risk management framework.

Explanatory considerations: LST on the assets side of the balance sheet

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

We agree with most of the explanatory considerations regarding LST of fund assets. We are however worried that some of these considerations could be read in a more prescriptive way depending on the competent authority's interpretation. We would therefore welcome some additional flexibility in the language so that these considerations remain seen as "examples", as stated in paragraph 22 and make the following drafting suggestion:

> 28. Scenarios. **If relevant and according to the investment strategy, m**anagers should employ historical, hypothetical scenarios **or** reverse stress testing. Scenarios should be appropriately chosen to achieve the effect of deteriorating liquidity on the assets of the portfolio, be it in terms of cost of liquidation, time to liquidation or other method.

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

Undertaking reverse stress testing is by definition a tailor-made and highly hypothetical exercise which can result in the exploration of an indefinite number of scenarios. Such tests are therefore currently generally conducted on an ad hoc basis, where they provide value to the risk management teams. Making them mandatory would lead to systematisation of such tests, and the necessary automation which would represent a very costly and complex process, especially in comparison to the low added value for many managers. Indeed, for many AIFs and UCITS managers, in order for such an exercise to be efficient, result in actionable data and provide information that is not already covered by historical or hypothetical stress testing, significant resources and time would need to be allocated. In order to strike the right balance between costs and efficiency, we therefore suggest that reverse stress testing be recommended only where relevant and where it adds useful information to the hypothetical and historical scenarios.

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 considerations to be made in any other fund or asset types, such as ETFs?

As regards additional considerations related to AIFs investing in so-called "less liquid assets", we would like to reiterate that liquidity stress testing is a variable concept. The liquidity profile of an asset can change overtime and the assets cannot be taken in isolation. We would therefore caution against any prescriptive requirements related to assets that could be characterised "less liquid" according to some aspects, as the same assets could have a very liquid profile according to other factors. Indeed some securities linked to real assets such as infrastructure or real estate could be seen as less liquid given the nature of the underlying asset, but could actually be easily disposable depending on investors' appetite or other macro-economic factors.

We would therefore welcome, as with the rest of the Guidelines, a high level and principle-based approach for any types of assets, regardless of their liquidity profile at one given time.

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

As mentioned above, we believe that an aggregation of LST will not be useful for most of AIFs and UCITS managers. This number does not take into account that each AIF or UCITS managed by the same asset management company will have different asset allocations or different types of investors. It also does not take into account the fact that most AIFs or UCITS management firms do not have a central chief risk officer. We therefore believe that such aggregation could be mentioned as an example and/or should be undertaken only if deemed appropriate by the manager.

Explanatory considerations: use of LST during a fund's lifecycle

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

With regards to requirement at fund launch, we would caution against attaching the approval of a product to the LST. The LST should be used as part of the overall risk management programme, knowing that in a fund product launch context, it is a very theoretical exercise.

Explanatory considerations: frequency of LST

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 the stakeholder(s) you represent?

The alternative investment management industry is often characterised by longer redemption periods and managers' ability to effectively manage liquidity issues since their investor base is mainly composed of professional or institutional investors who do not need daily liquidity. Usual redemptions period are monthly or quarterly, on top of which further liquidity tools can be added, such as gates, lock up or redemption notice periods. Imposing to this universe of funds quarterly

LST would not provide any additional benefit and we do not think such managers should provide specific justification for not complying with a quarterly frequency. Therefore, we would recommend reversing the recommendation and applying a quarterly LST requirement only where applicable and where appropriate.

Explanatory considerations: governance

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

We agree with the fact that LST should be properly embedded within the risk management framework of a fund. We believe however that the list of items to be included in the LST policy provided in section 68 could be read in a prescriptive way and seems too detailed to be appropriate for all kind of funds, strategies and type of investors. We therefore recommend that this list is used for illustrative purposes.

Explanatory considerations: depositaries

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

See comments on Guideline 15 p.6.