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10 March 2021

RE: ESRB ESMA Liquidity risk project

Dear Chair

In August 2019 and April 2020, the Central Bank of Ireland (Central Bank) wrote to fund management companies[1] reminding them of the importance of effective liquidity risk management and ensuring compliance with relevant legislative and regulatory obligations for UCITS and Alternative Investment Funds (AIFs)[2]. In particular, these letters focus on the need for:

- Calibrating liquidity risk management frameworks to take account of dealing frequency, investment strategy, portfolio composition and investor profile
- Regular liquidity stress testing
- Appropriate and transparent identification and deployment of liquidity management tools
- Board responsibility for the ongoing assessment of liquidity risk within funds under management

These communications were written in the context of Brexit preparedness and market uncertainty due to COVID 19. The importance of effective liquidity risk management is key at all times and has been reinforced by the period of stressed liquidity conditions witnessed across many markets in the wake of the COVID 19 outbreak.

A key observation from the COVID 19 period of market stress was that funds with exposures to less liquid assets, or assets that became temporarily illiquid were particularly susceptible to

[1] "fund management company" means a UCITS management company, an authorised Alternative Investment Fund Manager (AIFM), a self-managed UCITS investment company and an internally managed Alternative Investment Fund which is an authorised AIFM.

[2] Legislative and regulatory obligations include, in the case of UCITS, the Irish UCITS Regulations which implement the UCITS Directive and Level 2 Commission Directives (including 2007/16/EC and 2010/43/EU), and the Central Bank UCITS Regulations which incorporate CESR Guidelines on eligible assets for UCITS. In the case of AIFs, relevant obligations are set out in the Irish AIFM Regulations which implement the AIFM Directive and in the AIFMD Level 2 Regulation.

increased redemption requests. Redemption patterns observed in the data would be consistent with the operation of first-mover dynamics in parts of the sector. Indeed, redemptions were particularly concentrated in funds with exposures to less liquid assets in higher risk sectors, such as emerging markets and high-yield corporate bonds who faced a combination of falls in asset valuation, low market liquidity and large-scale outflows from investors. - The COVID 19 crisis also illustrates how the response of the sector as a whole to heightened redemption pressures – by selling assets, including less liquid assets, to meet those redemptions – can contribute to broader market-wide pressures.

On 6 May 2020, the European Systemic Risk Board (ESRB) requested that the European Securities and Markets Authority (ESMA): (1) coordinate with national competent authorities (NCAs) to undertake a focused supervisory exercise with investment funds that have significant exposures to corporate debt and real estate assets (the Review). The purpose of the Review was to assess the preparedness of these two segments of the investment funds sector to potential future shocks, including any resumption of significant redemptions and/or an increase in valuation uncertainty; and (2) report to the ESRB on its analysis and on the conclusions reached regarding the preparedness of the relevant investment funds. ESMA, the Central Bank and other EU NCAs coordinated this exercise and ESMA published its report on the findings on 12 November 2020 (the ESMA Report)[3].

The findings in the ESMA Report incorporated the findings from the Central Bank's supervisory analysis and engagement with selected funds, which were consistent with the overall findings of other NCAs. Your firm was selected to be part of this Review in relation to the corporate bond investment funds listed in Appendix 1. As such, the ESMA Report contains findings that are relevant to your firm and on which specific action is required as described in this letter.

In particular, the Review identified only a few funds that had adjusted their liquidity set up according to the pursued investment strategy and in light of the liquidity issues encountered (e.g. use of liquidity management tools (LMTs), dealing frequency, portfolio construction and notice/settlement periods). This indicates that, in these respects, many funds remain no better

[3] https://www.esma.europa.eu/sites/default/files/library/esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf

prepared for future liquidity shocks, periods of market volatility and increased redemptions than they were prior to the COVID-19 outbreak. This finding is also especially significant in light of the fact that the Review also identified that some funds presented potential liquidity mismatches due to their liquidity set up (e.g. high redemption frequency, no/short notice periods and no LMTs) combined with investments in assets that are illiquid or whose liquidity reduced during the period of market stress.

UCITS and AIFMD legislation[4] requires fund management companies to periodically review the adequacy and effectiveness of their risk management policies and procedures. In view of the findings of the Review, the Central Bank requires your firm to now consider how liquidity risk management frameworks and fund structures should be adapted to take into account the experience and lessons learned from the market and redemption activity in 2020 and the findings of the ESMA Report. This should also consider the steps needed to increase funds' resilience to future shocks. The following elements are important in considering what changes may be required:

- The alignment between the liquidity profile of funds' investments, the risk profile of investors, redemption policies and settlement periods and the development of new policies to correct misalignments in a timely manner. This is of particular importance for funds investing in less liquid assets or assets that have demonstrated variable levels of liquidity in 2020.
- Ensuring the full suite of liquidity management tools (LMTs) are in place and used appropriately. This should include consideration of the circumstances where LMTs are appropriate outside of stress scenarios, given their potential to enhance investor protection and dampen the effect of large increases in redemption requests on market conditions. Fund management companies should consider the extent to which the use of swing pricing or anti-dilution levies are required to ensure that transaction costs, including liquidity premia, associated with redemptions are borne by those exercising their redemption rights, limiting the effect of large redemption flows on remaining investors, particularly in times of stress and market volatility.

[4] Regulation 47(2) - Commission Delegated Regulation (EU) No 231/2013 Schedule 9(4) - European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011

- The firm's policies and procedures around the use of LMTs should include appropriate disclosure in fund documentation and communication with investors to ensure clarity and transparency around the regular use of LMTs and conditions for their implementation.
- The assessment of all other factors that could impact fund liquidity or trigger unplanned sale of assets. For example, the possibility of increased margin calls that may increase cash needs.
- A realistic and conservative estimate of which percentage of a fund's assets can be liquidated over certain time periods and ensure redemption policies are aligned with this assessment. Any mis-alignment in this regard should be corrected in a timely manner.
- Information on the profile of the investor base to better understand any potential risks associated with redemption patterns, particularly in stressed market conditions.
- Designing and testing funds' liquidity risk management frameworks and planning for future market disruption events should not assume government or central bank intervention of the nature or scale seen in 2020.

Your consideration of this matter should be concluded and the results presented to and approved by the Board of the fund management company no later than the end of June 2021, with an action plan to take any necessary steps promptly and in any event no later than the end of December 2021. A copy of the report presented to the Board should be available to the Central Bank on request.

This letter must be brought to the attention of all members of the Board of the fund management company, relevant designated persons and to the relevant responsible person(s) within delegate fund service providers.

Regards

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Appendix 1