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18 May 2021

Re: Common Supervisory Action on UCITS Liquidity Risk Management

Dear Chair,

In early 2020, the Central Bank of Ireland (the "Central Bank") commenced its review on UCITS liquidity risk management (LRM) as part of a Common Supervisory Action (CSA) coordinated by the European Securities and Markets Authority (ESMA). The purpose of the CSA was to assess UCITS Fund Management Companies' (UCITS managers)[1] compliance with their LRM obligations by simultaneously conducting supervisory activities throughout the EU/EEA.

The CSA on UCITS LRM, which has been the largest CSA undertaken to date, involved an in-depth assessment of UCITS managers' compliance with the applicable LRM rules by each of the 30 EU/EEA NCAs. Central to this exercise was the formulation of a common methodology and framework, alongside clear supervisory expectations, which allowed NCAs to assess UCITS managers in a consistent manner, ensuring a convergent supervisory outcome was achieved. The findings, which are highlighted in ESMA's recent public statement[2], incorporate the findings from the Central Bank's own supervisory analysis and engagement with UCITS managers (which were consistent with the overall findings of other NCAs).

To complete this body of work, the CSA was divided into two stages. Stage 1 required each in scope Irish UCITS manager to respond to a qualitative questionnaire on their LRM framework and submit a quantitative portfolio level breakdown of each UCITS under management. This resulted in submissions from 273 UCITS managers covering 3051 UCITS under management. Each submission was subject to detailed analysis in order to determine a subset of 20% of UCITS managers (equating to 55 UCITS managers) which would be subject to in-depth investigation in Stage 2 of the CSA. Each

[1] Including both UCITS Management Companies and Self-Managed Investment Companies (SMICs).
[2] ESMA Public Statement – Results of the 2020 CSA on UCITS liquidity risk management.

of these 55 UCITS managers were required to submit a quantitative security level breakdown of each UCITS under management and were subject to further supervisory engagement including desk-based reviews of procedures and processes and virtual inspections. A report detailing the Central Bank's findings was submitted to ESMA by year end 2020.

ESMA's public statement details a number of adverse supervisory findings and highlights the importance of market participants critically reviewing their LRM frameworks to ensure that none of the adverse supervisory findings are found in their LRM frameworks. The public statement also states that market participants should ensure compliance with all relevant UCITS regulatory requirements and associated EU and national guidance. Further, it notes that follow up actions will be undertaken by NCAs to ensure that regulatory breaches as well as other shortcomings or weaknesses identified are remedied. In the case of the Central Bank, supervisory engagement has commenced with UCITS managers where specific concerns were identified. This engagement has resulted in the Central Bank issuing 35 Risk Mitigation Programmes to date. In addition, findings from the CSA will inform policy development at both a national and European level.

In addition to its engagement with individual firms where findings were noted, the Central Bank is issuing this letter to all Irish authorised UCITS managers to require them to carry out a review of their activities in light of the findings of the CSA. We have also elaborated below on some of the findings from the CSA where we wish to highlight areas for attention by UCITS managers authorised in Ireland. As such this letter is to be read in conjunction with the ESMA public statement and does not take from the importance of any aspect of that statement which might not be referred to in this letter. It should also be read in conjunction with the results of the implementation of the ESRB recommendation on liquidity risks in investment funds[3], which defined five priority areas for consideration and the letter[4] issued by the Central Bank to a number of UCITS managers in the context of that exercise.

Action Required

In light of the seriousness of the findings of the CSA in the context of the importance of effective LRM frameworks, all Irish authorised UCITS managers are required to conduct a specific review of their practices, documentation, systems and controls by reference to the findings in the ESMA public statement and this letter. This review must be documented and must include details of

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[3] Report on ESRB recommendations on liquidity risks.
[4] ESRB ESMA liquidity risk project – letter to Fund Management Companies 10 March 2021.

actions taken to address any of the findings in the ESMA public statement and this letter. This review should be completed and an action plan discussed and approved by the board of each UCITS manager by end of Q4 2021.

As detailed above, the review should have regard to the findings set out in the ESMA public statement and the following specific items relating to those findings[5] detailed in the Appendix to this letter:

- Instances of LRM frameworks that were not clearly defined, adaptable and/or independent
- A lack of formal documented pre-investment forecasting frameworks
- A lack of formal liquidity escalation policies
- Cases where no pre-investment forecasting performed
- Over-reliance on the presumption of ongoing liquidity
- Oversight of delegates below expectations
- Shortcomings in the role of the designated person for fund risk management
- Cases of no liquidity reporting to the board of the UCITS manager
- Shortcomings in internal control framework

Liquidity risk management will continue to be an area of supervisory focus by the Central Bank. In circumstances of non-compliance by any firm with any regulatory requirements relevant to the matters raised in this letter, the Central Bank may, in the course of future supervisory engagement, or when exercising its supervisory and/or enforcement powers in respect of such non-compliance, have regard to the consideration given by a firm to the matters raised in the ESMA public statement and this letter.

Should you have any queries regarding the content of this letter, please contact ucitsliquidity@centralbank.ie.

Yours sincerely

Patricia Dunne

Patricia Dunne
Head of Securities and Markets Supervision Division

[5] Findings are presented in detail in Appendix 1.

Appendix 1

Instances of LRM frameworks that were not clearly defined, adaptable and/or independent

The Irish UCITS Regulations[6] requires UCITS managers to establish, implement and maintain an adequate and documented risk management policy which identifies the risks the UCITS they manage are or might be exposed to[7]. The Central Bank identified instances whereby UCITS managers were not able to provide a single cohesive documented LRM framework. Instead, an assortment of procedures and processes that referenced liquidity risk were submitted, which when combined, was stated by the UCITS manager to constitute their LRM framework. The Central Bank expects UCITS managers to employ a cohesive, comprehensive, practical, live documented LRM framework that accounts for all known dynamics relating to liquidity risk. LRM frameworks should be forward looking, adaptable and independent of unrelated external influence.

The Central Bank also requires that UCITS managers consider how LRM frameworks and fund structures should be adapted to take into account the experience and lessons learned from the market and redemption activity in 2020. This includes considering the profile of the investor base to better understand any potential risks associated with redemption patterns, particularly in stressed market conditions. The Central Bank identified UCITS managers who were not performing sufficient detailed analysis of their investor base. UCITS managers must make efforts to understand their investor base in order to fully comprehend and manage liquidity risk and employ the correct liquidity strategy. As demonstrated by the market volatility of 2020, liquidity can deteriorate quickly, and redemption requests are the most obvious and important source of liquidity risk facing UCITS.

Under Irish UCITS Regulations a UCITS is required to redeem or repurchase units/shares at the request of investors[8] and UCITS managers shall ensure that for each UCITS they manage the liquidity profile of the investments of the UCITS is appropriate to the redemption policy laid down in the fund rules or the instruments of incorporation or the prospectus[9]. The Central Bank observed that certain fund platforms and distributors have specific requirements in respect of dealing and settlement periods and the potential for this or other commercial matters to influence decision

[6] S.I. No. 352/2011 - European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (Irish UCITS Regulations)
[7] Schedule 9 of the Irish UCITS Regulations
[8] Regulation 104 of the Irish UCITS Regulations
[9] Paragraph 10 of Schedule 9 of the Irish UCITS Regulations

making with regard to UCITS managers' LRM frameworks. UCITS managers are reminded that they must ensure that their LRM frameworks are not unduly influenced by external commercial matters, but are instead driven by, inter alia, the liquidity profile of the UCITS and profile of its investors.

A lack of formal documented pre-investment forecasting frameworks

The Central Bank identified instances of pre-investment forecasting being carried out in an ad-hoc and subjective manner without a clearly defined or documented methodology overseeing how it is being performed. In accordance with the Irish UCITS Regulations, UCITS managers must establish, implement and maintain an adequate and documented risk management policy which identifies the risks the UCITS they manage are or might be exposed to[10]. A documented framework that sets out the expectations and required actions in respect of pre-investment forecasting forms an important part of the overall risk management policy with respect to LRM. Therefore UCITS managers are required to ensure that this framework is incorporated into their risk management policies and procedures and that it meets the standards for risk management policies set out in the Irish UCITS Regulations.

A lack of formal liquidity escalation policies

The Central Bank identified a number of UCITS managers who did not have clearly defined and documented escalation procedures in respect of liquidity risk. In these cases, specific liquidity escalation thresholds and/or alerts to the board of directors of the UCITS manager were not stipulated at all or where they were stipulated, this was not done in sufficiently clear terms to be operational in practice. This inherent lack of a formalised criteria which triggers the escalation process, increases the risk that items will not be escalated through the appropriate channels and will not be properly managed and mitigated. UCITS managers must have a formal process in place with quantitative measures supported by qualitative judgements and clear responsibilities for the identification and escalation of liquidity issues and/or concerns to the board. In accordance with the Central Bank's Fund Management Companies Guidance[11] ("the FMC Guidance"), designated persons are required to propose and agree with the board of directors of UCITS managers, appropriate thresholds and key performance indicators which trigger immediate escalation from delegates and designated persons to the board[12].

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[10] Paragraph 1(a) of Schedule 9 of the Irish UCITS Regulations
[11] Fund Management Companies – Guidance December 2016
[12] Part IV, paragraph 21 'Escalation to the Board' of the FMC Guidance

Cases where no pre-investment forecasting performed

The Central Bank identified a number of cases where UCITS managers did not perform pre-investment forecasting, and instead relied on the presumption of liquidity for each investment. This is particularly concerning with respect to investments in financial instruments which are not admitted to or dealt on a regulated market. In accordance with the Irish UCITS Regulations, UCITS managers are required, where it is appropriate, to formulate forecasts and perform analyses concerning their individual investment's contribution to the UCITS portfolio composition, liquidity and risk and reward profile before carrying out the investment[13]. Further, the Central Bank UCITS Regulations[14] set out granular provisions in relation to the assessment of liquidity risk when investing in any transferable security and also require that the liquidity and negotiability of transferable securities not admitted to or dealt on a regulated market are assessed and documented[15]. In particular, given the nature of securities which are not admitted to trading on a regulated market and their heightened liquidity risk, failure to perform pre-investment forecasting for such investments is not fully compliant with the relevant regulations.

Over-reliance on the presumption of ongoing liquidity

During the course of the CSA, the Central Bank identified cases where UCITS managers placed an over-reliance on historical performance as testament to the soundness of their LRM frameworks, instead of increasing preparedness for future liquidity events. In such instances managers relied heavily on the presumption that liquidity should not be an issue in the future where there had not been individual liquidity issues observed in the past.

This presumption of liquidity is especially concerning when considering the events of 2020 and the impact the extraordinary government and central bank supports had in mitigating the 2020 period of market stress. In the absence of not adequately factoring in periods of future market stress, UCITS may remain vulnerable during such scenarios where central bank and government support is not available swiftly, to the same extent or not at all.

UCITS managers are required under the Irish UCITS Regulations[16] to conduct stress testing and scenario analysis, where appropriate. Moreover, the ESMA Guidelines on liquidity stress testing in

[13] Paragraph 8(1) of Schedule 5 of the Irish UCITS Regulations
[14] S.I. No. 230/2019 - Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2019 (Central Bank UCITS Regulations)
[15] Regulation 4(2) of the Central Bank UCITS Regulations
[16] Paragraph 9(2) of Schedule 9 of the Irish UCITS Regulations

UCITS and AIFS[17] contain further granular guidance providing that UCITS managers conduct stress testing for future hypothetical scenarios, including exceptional liquidity events, which enable the assessment of risk under such conditions.

Oversight of delegates below expectations

The Central Bank identified a number of cases where there was a lack of effective engagement with delegated investment managers. This was found through both a lack of evidence of liquidity reporting from delegates to UCITS managers and also, a lack of evidence of UCITS managers challenging their delegate investment managers in relation to LRM. The Central Bank expects that UCITS managers have regular engagement with delegate investment managers through receipt of ongoing liquidity reporting and evidence of regular challenge and interaction with them. As prescribed by the FMC Guidance, it is necessary that the board of the UCITS manager exercise skill, care and diligence in its continuing oversight of delegates through the review of reporting from appropriately authorised personnel of the delegate[18].

Shortcomings in the role of the designated person for fund risk management

The Central Bank identified UCITS managers whose designated persons' oversight and input into the relevant LRM frameworks was not at the expected standard. While it was evidenced that these designated persons were in receipt of regular liquidity reporting, there was no evidence provided of constructive challenge, analysis or commentary by the designated person on the reporting received. This ultimately impacts on the quality of the liquidity reporting provided to the board of the UCITS manager. As outlined in the FMC Guidance, designated persons are required to approach information received from delegates with healthy scepticism. They should not necessarily accept such information at face value and should interrogate information received. Designated persons should constructively challenge delegates and should follow up on issues raised to ensure that they are concluded satisfactorily[19].

No liquidity reporting to the board of the UCITS manager

The Central Bank identified a number of UCITS managers whose board of directors did not receive liquidity reporting. UCITS managers are required (through the implementation of their risk management policy) to identify the risks to which their UCITS may be exposed and how those risks

[17] ESMA Guidelines on liquidity stress testing in UCITS and AIFs
[18] Part I, paragraph 21 'Delegated tasks' of the FMC Guidance
[19] Part IV, paragraph 42 'Approach to information received from delegates' of the FMC Guidance

are to be monitored and measured vis-à-vis the UCITS positions and those positions' contribution to overall risk profile of the UCITS. The reporting of liquidity risk and the manner in which it is reported to the board of directors of the UCITS manager is therefore an essential part of a properly functioning and robust risk management policy.

In accordance with the Irish UCITS Regulations, it is a requirement that the risk management policy of the UCITS manager must state the terms, contents and frequency of reporting to the board of directors[20].

Shortcomings in internal control framework

The Central Bank identified failures with the internal control frameworks within UCITS managers as evidenced by the fact that the frameworks did not identify certain key findings and shortcomings outlined in the ESMA publication and this letter. UCITS managers must ensure that second-level controls, e.g. compliance functions, and where appropriate and proportionate, third level controls, i.e. internal audit functions, have sufficient input into and oversight of LRM frameworks to ensure they are operating effectively.

As per the Irish UCITS Regulations UCITS managers must establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the management company[21].

[20] Paragraph 2 of Schedule 9 of the Irish UCITS Regulations
[21] Paragraph 1(c) of Schedule 4 of the Irish UCITS Regulations