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Liquidity Stress Testing for Corporate Debt and Real Estate Funds

by **David Naughton, Katrina Smyth**

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The European Securities and Markets Authority (ESMA) has announced that corporate debt and real estate funds do not pose any substantial risk in terms of financial stability, but that there is "room for improvement and continued monitoring" in specific areas.

ESMA undertook a period of supervisory engagement with investment funds and National Competent Authorities (NCAs) on liquidity risk in corporate debt and real estate funds.

ESRB Recommendation

The European Systemic Risk Board (ESRB) published a Recommendation to ESMA (ESRB/2020/4) on 6 May 2020. The Recommendation was a response to the COVID-19 pandemic and an initiative to address liquidity risk in investment. High volatility and inherent valuation issues triggered by the pandemic had resulted in large market corrections and a deterioration of liquidity risks, which resulted in stress in the investment fund sector.

The ESRB identified funds with significant exposures to corporate debt and real estate as particularly high priority for enhanced scrutiny from a financial stability perspective.

The ESRB recommended that ESMA coordinate with NCAs on a focused supervisory engagement with such funds, and report back to the ESRB. The aim of the engagement was to assess the preparedness of these less liquid asset categories to deal with potential future redemption and valuation shocks.

ESMA's Response

In response, ESMA coordinated a supervisory exercise, which included the collection of data by NCAs on funds exposed to corporate debt and/or real estate, focusing on potential future redemptions and/or valuation uncertainty shocks and whether additional actions were required.

ESMA published a report, "Recommendation of the European Systemic Risk Board (ESBR) on liquidity risk in investment funds" (ESMA's Final Report), in which it set out its analysis and conclusions. The Final Report, published in November 2020, found that only a limited number of analysed funds had suspended subscriptions and redemptions, while the vast majority had been able to meet redemption requests and maintain their portfolio structure during the first half of 2020.

However, this was in the context of low redemptions and the Final Report identified important areas with weaknesses, with significant issues around valuation, availability of liquidity management tools (LMTs) and loan covenants. In particular, five Priority Areas were identified for ongoing supervision and monitoring by NCAs, to enhance the preparedness of these less liquid funds to potential future adverse shocks.

The five Priority Areas are:

1. Alignment of a fund's investment strategy, liquidity profile and redemption policy;
2. Liquidity risk assessment.
3. Fund liquidity profiles.
4. Increase of the availability and use of LMTs.
5. Valuation processes in the context of valuation uncertainty.

See also ESMA's Public Statement.

ESMA's Recent Follow-Up on Priority Areas

In a Press Release dated 30 March 2022, ESMA announced that, to foster supervisory convergence amongst NCAs in how they monitor compliance by funds with their obligations, it had followed up on the steps undertaken by NCAs with regard to Priority Areas.

Many NCAs reported back to ESMA that fund management companies had been able to manage episodes of valuation uncertainty in March 2020, and those NCAs had not identified any strong valuation issues for the funds in scope of the supervisory exercise.

However, ESMA found that, while the overall degree of compliance is satisfactory, there is some room for improvement and continued monitoring, with a particular focus on liquidity stress testing and valuation of less liquid assets. Accordingly, funds should be aware that there will be continued supervisory engagement in these areas during 2022.

Next Steps During 2022

1. ESMA will facilitate discussions among NCAs on the application of the Liquidity Stress Testing guidelines in UCITs and AIFs.
2. ESMA is conducting a 2022 Common Supervisory Action on the valuation of less liquid assets in UCITS and open-ended AIFs.

For more information:

For further information on this topic, please contact David Naughton at dnaughton@lkshields.ie or Katrina Smyth at ksmyth@lkshields.ie.

About the Authors

David Naughton
Partner

David Naughton is Head of Financial Services.
T: +353 1 637 1585 **E:** dnaughton@lkshields.ie

Katrina Smyth
Senior Associate

Katrina is an experienced financial services solicitor specialising in Investment Funds and Asset Management.
T: +353 16371548 **E:** ksmyth@lkshields.ie