ESMA publishes a report on funds' resilience to future shocks

Insights - 23/11/2020

On 12 November 2020, the European Securities and Markets Authority (**ESMA**) published a report presenting its analysis and conclusions on the readiness of certain investment funds that have significant exposure to corporate debt and real estate assets to potential future adverse shocks, as well as five priority action areas which would contribute to their future preparedness.

This report comes as a result of a coordinated supervisory exercise performed alongside national competent authorities (**NCAs**), following a recommendation issued by the European Systemic Risk Board (**ESRB**) in May.

The research indicated that, overall, activities of funds exposed to corporate debt and real estate, were adequately maintained when confronted with redemption pressures and valuation uncertainties, which resulted in a limited number of suspended subscriptions and redemptions. As highlighted by ESMA, this should be viewed through the lense of government support during the period under review and the fact that the initial market shock caused by the pandemic was of short duration.

However, concerns have appeared over potential liquidity mismatches of funds investing in illiquid asset classes offering high redemption frequencies and short notice periods, as well as the long-term impact on real estate funds which do not adopt sufficient Liquidity Management Tools (**LMTs**).

ESMA has identified five priority areas for funds and/or managers, in order to enhance the funds' preparedness and NCAs' role in that context:

1. **Ongoing supervision of the alignment of the funds' investment strategy, liquidity profile and redemption policy**

   Market participants - responsible for ensuring the alignment between the liquidity profiles of investments and their redemption policies, as well as necessary corrections. Management companies should be able to justify the liquidity set-up of their funds.

NCAs – supervising compliance with rules on liquidity risk management by actively engaging with and supervising their market participants. Misalignments between the liquidity profile of funds' investments and their redemption policies should be corrected in a timely manner.

2. Ongoing supervision of liquidity risk assessment

NCAs - supervision of liquidity risk assessments by management companies, with a particular focus on including factors that could have an impact on liquidity or trigger unwanted sales of assets (eg margin calls which may increase cash needs in case of renewed heightened market volatility and loan covenants in real estate funds).

3. Fund liquidity profile reporting

In the context of the AIFMD review, ESMA highlighted the need to include, in the reporting framework, additional specifications on how liquidity profiles should be established and reported (on the asset side, realistic estimates of possible liquidation percentages for each asset class and, on the liability side, taking into consideration arrangements related to gates and notice periods in the determination of investor liquidity profiles).

4. Increase of the availability and use of LMTs

ESMA has again made reference to its letter to the EU Commission on the AIFMD review, pointing out that the framework governing availability of additional liquidity management tools for managers should be harmonised and include disclosure specifications on the use of LMTs to increase investor protection.

5. Supervision of valuation processes in a context of valuation uncertainty

NCAs – recommendation to perform further supervisory actions in order to ensure that valuation procedures laid down by management companies cover all situations, including those of stressed market conditions. Especially in cases of portfolio management delegation, sufficient expertise needs to be in place to ensure fair valuation based on reliable sources.

These actions should, in ESMA's view, reduce the risks and impacts of collective selling by addressing liquidity and valuation risks at the level of the fund, which will continue to be monitored through regular assessments of the fund sector resilience. ESMA will continue to collaborate with NCAs in order to promote supervisory convergence in stressed market conditions by reinforcing its coordination role through frequent exchanges on market developments and supervisory risks, as well as through regular data collection on the use of LMTs.

About Ogier

Ogier is a professional services firm with the knowledge and expertise to handle the most demanding and complex transactions and provide expert, efficient and cost-effective services to all our clients. We regularly win awards for the quality of our client service, our work and our people.

Disclaimer

This client briefing has been prepared for clients and professional associates of Ogier. The information and expressions of opinion which it contains are not intended to be a comprehensive study or to provide legal advice and should not be treated as a substitute for specific advice concerning individual situations.

Regulatory information can be found under Legal Notice

Meet the Author

Anne-Gaëlle Delabye

Partner

Luxembourg Legal Services

E: anne-gaelle.delabye@ogier.com

T: +352 2712 2039

Related Services

Investment Funds

Legal

Related Sectors

Funds Hub