



Liquidity risk of funds in the spotlight

Webinar

Mohamed Ed-Diaz

Manager, Arendt Regulatory &
Consulting

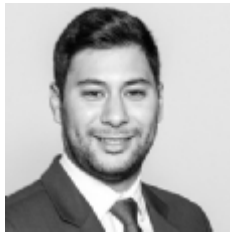
David Rath

Senior Advisor, Arendt Regulatory &
Consulting

14/09/2020

arendt.com

The speakers



Mohamed Ed-Diaz

Mohamed.ed-diaz@arendt.com

T +352 26 09 10 77 38

M +352 621 17 41 66



David Rath

David.Raths@arendt.com

T +352 26 09 10 77 32

M +352 621 28 37 92

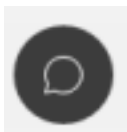
Hello and welcome!

Let's enjoy an interactive session



Q&A – please send your questions to the panelists

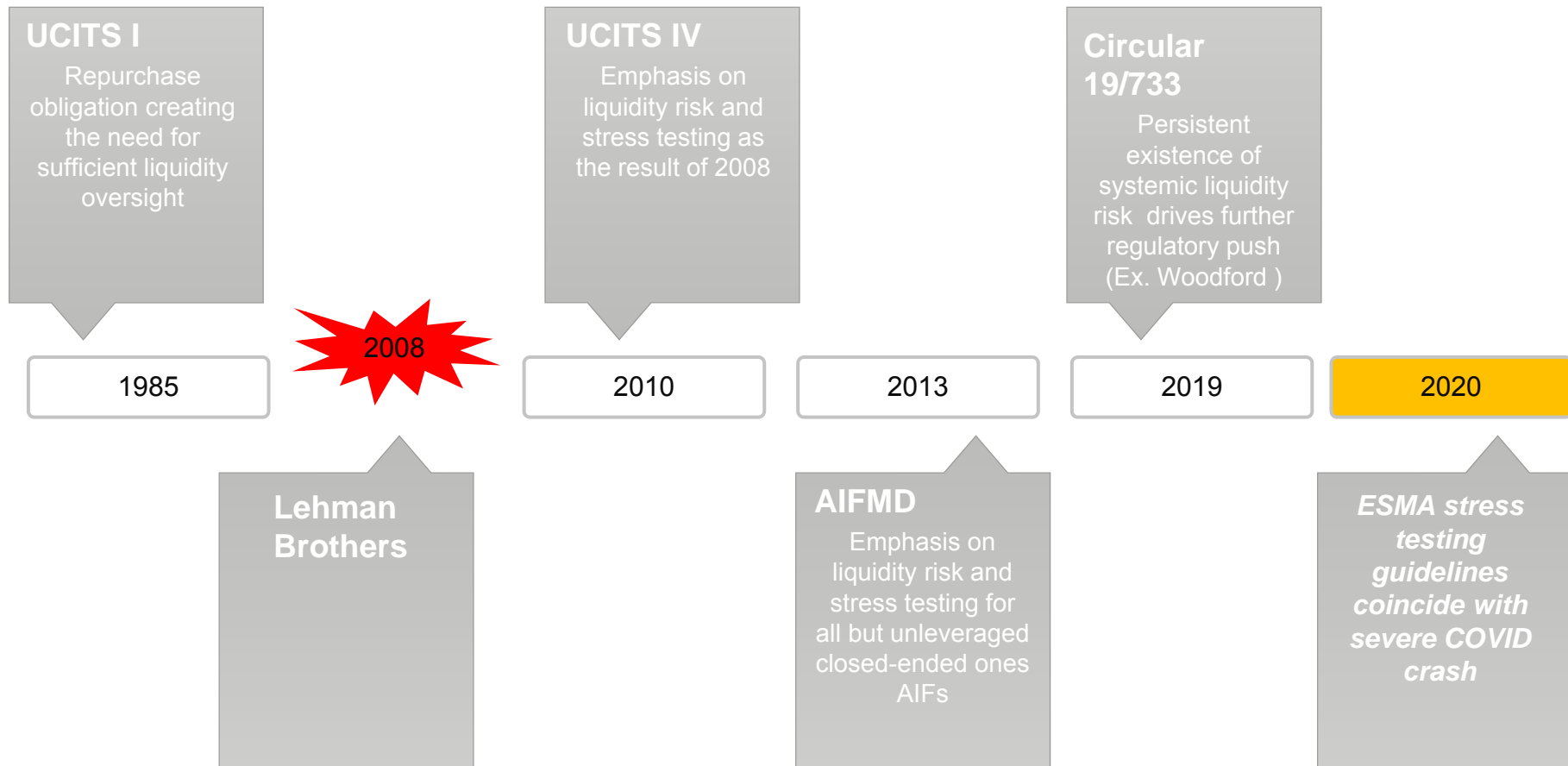
You can access the Q&A section by clicking on the 3 dots button in the toolbar at the bottom of your screen.



Chat – should you have technical issues, please write us in the chat

You can access the chat section by clicking on the icon in the toolbar at the bottom of your screen.

1. Regulatory evolution of Liquidity risk



2. Introduction and definitions: Liquidity risk in a nutshell



Definition

- Liquidity risk is the risk that an UCI does not feature a sufficiently liquid asset base, i.e. assets that cannot be sold or liquidated at a limited cost within a short time frame, in order to meet payables or investor redemptions where such apply.

Open-ended vs (leveraged) closed-ended liquidity characteristics

- Open-ended funds
 - A UCI offering redemption rights to its investors
 - ✓ low volume in the market vs. high demand for redemptions
 - ✓ Significant decrease of asset value
- Leveraged closed-ended funds
 - A UCI not offering any redemption rights:
 - ✓ inability to meet debt repayment
 - ✓ inability to meet margin call(s)
 - ✓ missing an opportunity due to investor default

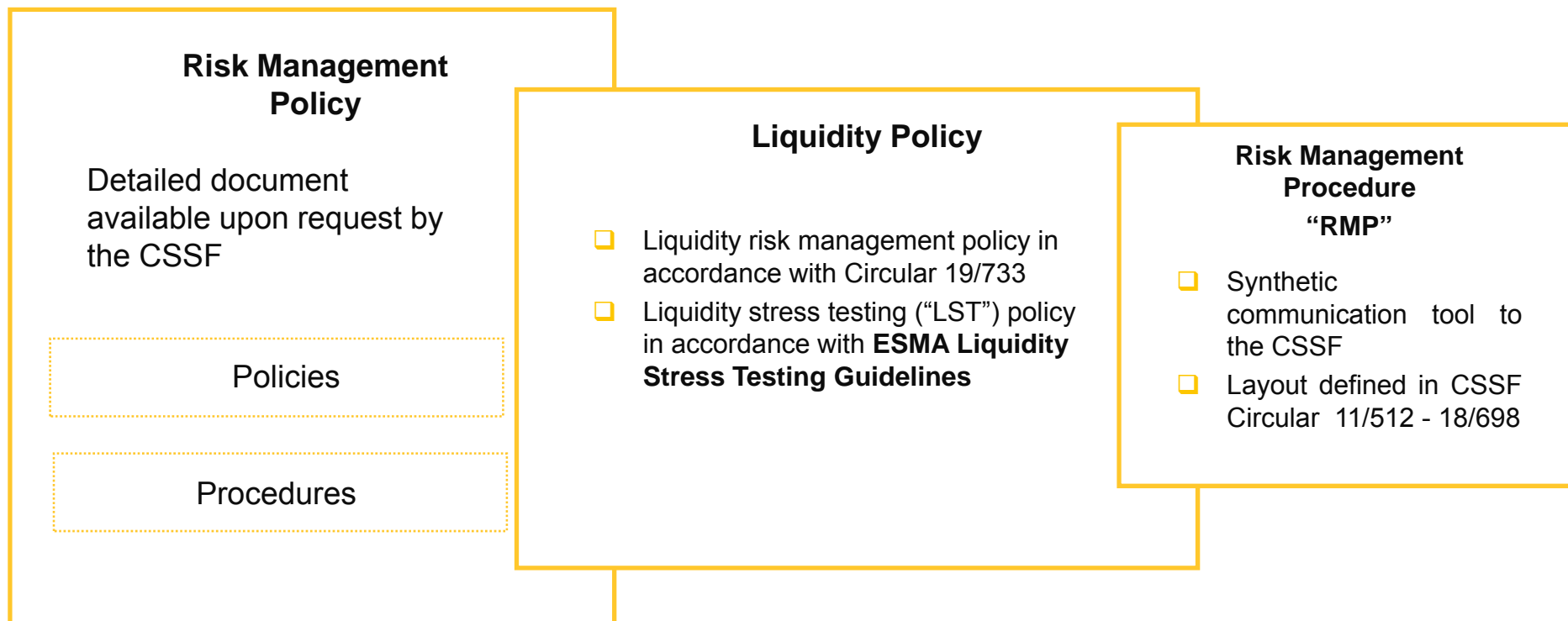
3. Risk management framework



- ✓ AIFM Law
- ✓ UCITS Law
- ✓ CSSF Circular 18/698

- ✓ CSSF Circular 19/733
- ✓ ESMA LST guidelines

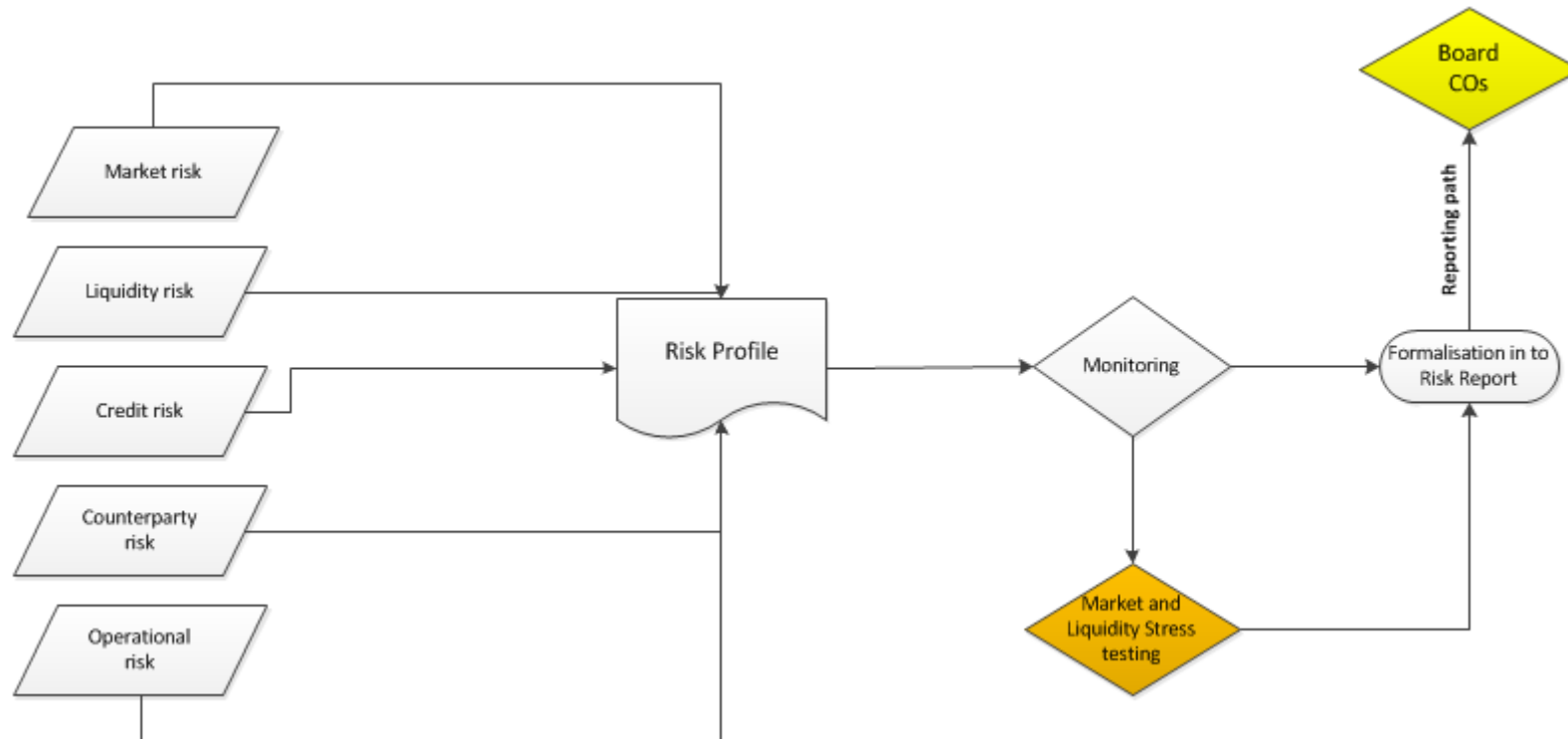
- ✓ CSSF Circular 18/698
- ✓ CSSF Circular 11/512



3. Risk management framework



- The risk management framework is translated in a **fund-specific risk profile** which in turn forms the basis for recurring risk reporting by the risk management function of the AIFM to **the board of directors of the fund & the AIFM**.



4. Introduction of Circular 19/733

- Scope: **For open-ended funds only**
- Implications:
 - **The Design Process: Prior to a fund launch**
 - Set appropriate liquidity thresholds
 - Match appropriately dealing/redemption frequency to investment strategy and allocate applicable risk metrics.
 - **Day to day liquidity management: During the fund life**
 - Assess liquidity state in different scenarios based on defined metrics
 - Ensure appropriate records are kept, and relevant disclosures made, relating to the performance of its liquidity risk management process
 - **Contingency planning**
 - Put in place and periodically test contingency plans (i.e., gating, bridge financing, etc.), and other liquidity risk management tools (“**LMT**”) in order to protect investor interests.

4. Liquidity risk – Classifications

- Based on **Circular 19/733**, liquidity risk is classified into two categories:
 - **Asset side liquidity**
 - Market liquidity risk - the risk that a given security or asset cannot be sold quick enough to raise liquidity when required or to prevent a loss in cases where the fund's illiquidity is related to its investment strategy
 - **Liability side liquidity**
 - Funding liquidity risk – risk arises when there is inconsistency between redemption rights and the liquidity of the assets, such as:
 - inability to pay redemptions proceeds;
 - inability to pay fund liabilities;
 - inability of fund to pay margin call requests.

4. Liquidity risk – Process flow



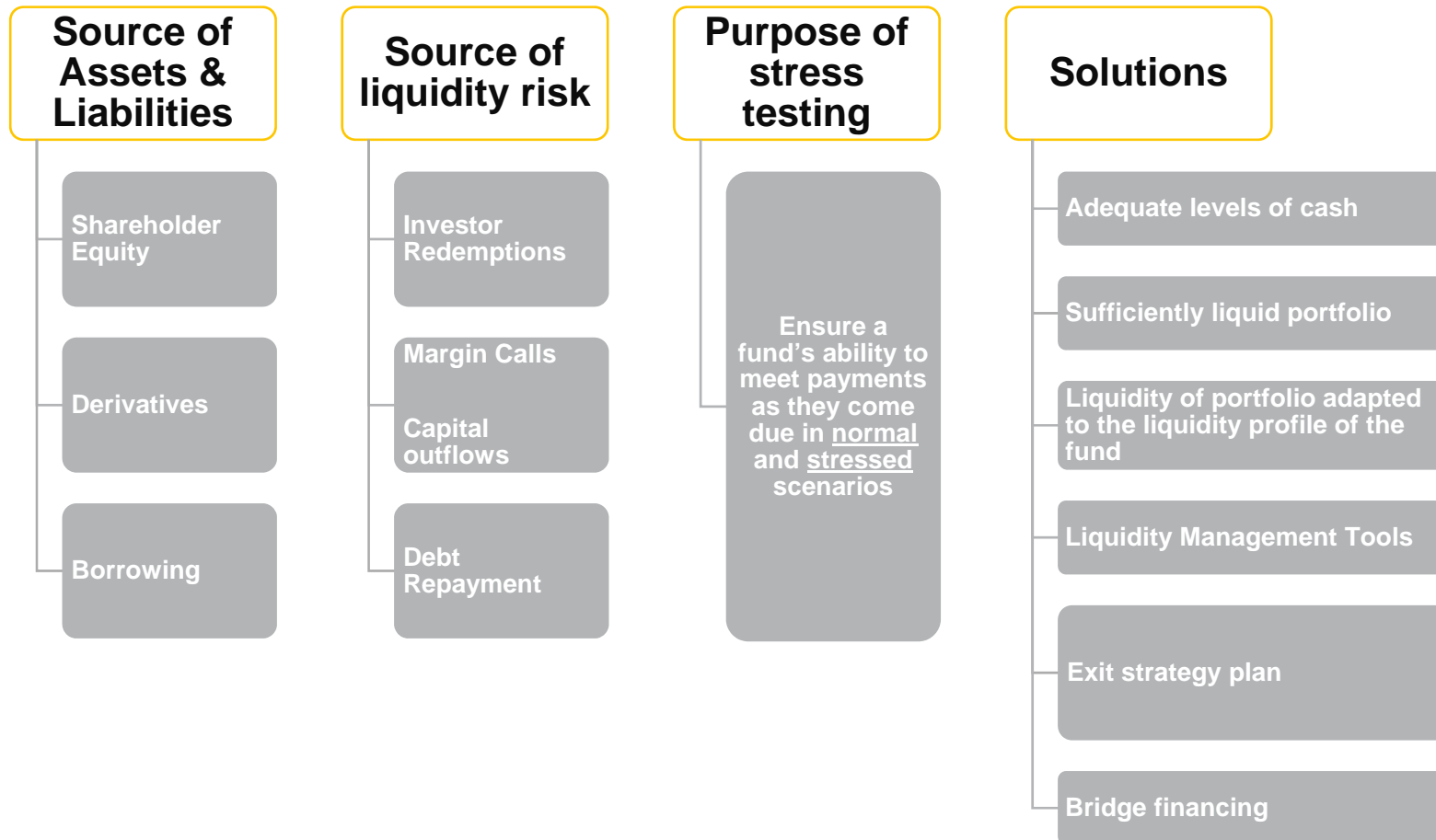
General 5-step process:

1. Assess the type of fund:
 - a) Open-ended or closed-ended UCIs
 - b) Leveraged or unleveraged UCIs
2. Perform an Asset (and liability, if applicable) Liquidity Bucketing exercise:
 - Cash and cash equivalents
 - Time to liquidate 2 – 7 days
 - Time to liquidate 8 – 30 days,
 - Time to liquidate 31 – 90 days, etc.
3. Assess liquidity gaps:
 - a) Anticipate cash flow projection / cash uses
 - b) Anticipate cash sources
 - c) Assess **liquidity management tools**
4. Perform gap analysis and assess the **contingency plan** in place
5. Perform **stress testing exercise** on both the market and liquidity risk layer

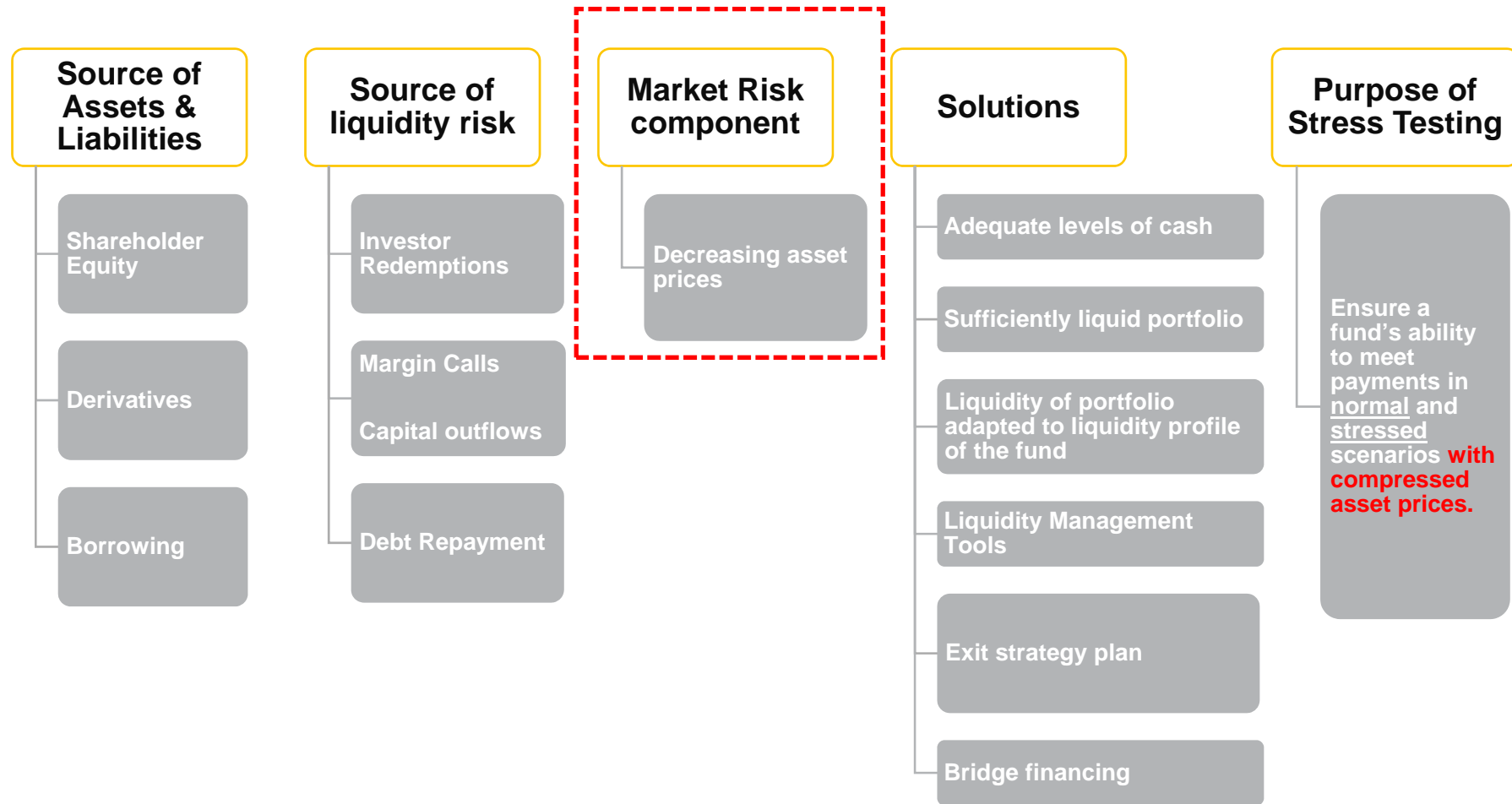
5. Integrating liquidity stress testing (“LST”)



- Scope: For all but closed-ended unleveraged funds



5. Integrating LST – Adding market risk component



5. Integrating LST – ESMA LST guidelines



- Ready the UCI range for depressed market environments as expressed by:
 - Price drops or lack of valuation reliability
 - Steep drops in available market liquidity
 - Increasing liquidation costs due to dried-up markets
 - Unfavorable refinancing conditions
 - ... etc.
- Implement a sound governance and reporting process for recurring stress testing exercises
- Liquidity stress testing considerations to be included in the design process of the UCI

5. Integrating LST – ESMA LST guidelines



- **The LST Policy**
 - Formalize the stress testing framework into a written policy to be **approved by the board of the AIFM** detailing:
 - the role and responsibility of the senior management,
 - the interaction of LST with other liquidity risk management procedures,
 - Periodic review and documentation of the results,
 - Initial validation and ongoing backtesting of the LST models, frequency and assumptions.

- **LST frequency**
 - **At least annually** (mandatory) or **quarterly** (recommended). To be aligned with a UCIs dealing frequency if more frequent.

- **LST on entire capital structure (assets + liabilities)**
 - **Liquidation cost** and **time to liquidity** are the two principal approaches to observe asset liquidity and to be compared to payables and/or redemptions.

6. Requirements



| Regulations | Type of Funds | | | |
|---------------------|---------------|-------------|--------------|-------------|
| | Open-ended | | Closed-ended | |
| | Leveraged | Unleveraged | Leveraged | Unleveraged |
| Circular 19/733 | ✓ | ✓ | ✗ | ✗ |
| ESMA LST Guidelines | ✓ | ✓ | ✓ | ✗ |

7. What are the challenges?



■ UCITS

- Ensuring the compliance of the risk management function and stress testing with the regulatory framework
- Review of the redemptions policy alignment to the legal set-up in place
- Data and model challenges (market data/redemption modelisation)

■ AIFs

- Risk management is not standardised
 - Real Estate, Private Equity, Fixed Income, Hedge Fund etc...
- Leverage
 - Gross vs Commitment approach / Primary vs Secondary Layer
- Ensuring that the risk management function and stress testing are adequately address all types of managed AIFs – Avoid one size fits all approach

Contact Us

Arendt Regulatory & Consulting S.A.
Advisory services - Risk management

41A, avenue J.F. Kennedy
L-2082 Luxembourg

RiskTeamARC@arendt.com
T +352 26 09 10 7738





Visit our dedicated page ***Arendt Covid-19 Solutions*** and install the ***Arendt Insights App*** to find the most frequently asked questions and our answers



<http://bit.ly/ArendtCovid19Solutions>



<https://apps.apple.com/lu/app/arendt-insights/id1506580191>

Important Notice and Disclaimer : Whilst a best efforts approach has been taken to ensure the accuracy of the information provided in this presentation, as at the date thereof, this information is only designed to provide with summarised, and therefore non complete, information regarding the topics covered. As such, this presentation does not constitute legal advice, it does not substitute for the consultation with legal counsel required prior to any undertakings and it should not be understood as investment guidelines. If you would like to receive a legal advice on any of the issues raised in this presentation, please contact us.

arendt.com