AUTORITÉ DES MARCHÉS FINANCIERS

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The AMF publishes its findings after a European common supervisory action on liquidity management in UCITS

The Autorité des Marchés Financiers (AMF) presents the findings of a supervisory exercise coordinated by ESMA on liquidity risk management in UCITS in France. Since proper consideration of liquidity risk is essential for UCITS, the AMF is asking asset management companies to strengthen their procedures, especially for UCITS with a particular liquidity risk.

In 2020, the AMF took part in the European common supervisory action on liquidity management practices in UCITS funds, coordinated by the European Securities and Markets Authority (ESMA). The aim was to ensure that the practices of asset management companies comply with the regulations and allow them to effectively meet investors' redemption requests at all times. Following ESMA's publication of the main observations at the EU level, the AMF is publishing a summary of its findings concerning French asset management companies.

The AMF sent a questionnaire to 220 asset management companies, representing more than 80% of the companies managing UCITS. This first exercise enabled it to select a smaller sample of 55 asset management companies for a more in-depth analysis by sending out a second questionnaire. The AMF completed the process with a series of SPOT (Supervision of Operational and Thematic Practices) inspections of four institutions and in-depth interviews with a dozen players.

The AMF focused in particular on the following topics:

- pre-investment checks on fund liquidity (checks on the intrinsic liquidity of planned investments and checks on the impact of these planned investments on the funds' liquidity profile);
- the global monitoring system for liquidity risk of a UCITS fund and the governance of this monitoring;
- market data and assumptions regarding asset liquidation of the UCITS fund;
- taking into account the liquidity risk needs of the fund in connection with the use of derivatives;
- taking into account liquidity needs of funds linked toshare redemptions in the liquidity management procedures;
- use of liquidity management tools.

Pre-investment assessment

A significant number of asset management companies that do carry out a pre-investment assessment of the impact of their investments on the liquidity of the funds under management do not formalise it. Market participants explained the lack of due diligence or the lack of proper formalisation as a result of the presumption of liquidity permitted for certain financial instruments and under certain conditions by the regulations, and the application of several predefined and calibrated risk limits to control liquidity risk in the funds under management. The AMF believes that the use of this presumption should be documented and justified more systematically. Among the good practices observed, the regulator noted the existence of systems for identifying securities whose liquidity is deemed to be inadequate and, if necessary, for blocking orders that might be placed for these securities.

Formalisation of the monitoring system

Generally, asset management companies have post-investment liquidity risk monitoring systems in place. The level of formalisation of the characteristics and conditions of implementation of this system in procedures varies. These procedures should provide more detailed information about the practical arrangements for monitoring liquidity risk, including how to formalise and archive the controls performed. The AMF also noted that the calculation assumptions and scenarios on which these monitoring systems are based are not sufficiently justified or that their justification is not always documented. Lastly, the procedures generally do not specify the conditions under which the validity of these assumptions and scenarios is reassessed by the asset management companies.

Reporting to management

Asset management companies do provide their executives with reports on liquidity risk as part of periodic risk monitoring committees, especially for larger entities, or in some cases more informally for smaller entities. The AMF noted that good practices include adjusting the frequency and depth of reporting to management to the risk level of each fund and the type of assets held.

Liquidity risk assessment methodologies

Generally speaking, most asset managers use the same methodologies for estimating liquidity risk for equity investments. However, they are based on heterogeneous assumptions regarding the levels of participation in trading volumes, the observation period of these volumes, and the data taken into account. It is important to ensure the validity of the assumptions chosen and, if necessary, to adjust them to market circumstances. For interest rate instruments, in the absence of market volume data, the parameters taken into account are variable. When they can, entities use liquidity grids provided by their trading desk, the relevance of which is not always subject to formalised ex-post reviews.

Liquidity needs related to the use of derivatives

Most of the asset management companies examined consider margin calls to be a reconciliation and cash management issue with no potential impact on financial management. The first level of consideration when dealing with margin calls is to maintain a pocket of liquidity or highly liquid assets to meet them. In most cases, the asset management companies concerned do this without using a documented estimate of the amount of this pocket. The risk of an increase in initial margin deposits in connection with an increase in volatility is not taken into account. However, the way clearing houses take the increase in volatility into account is available to management companies.

The application of ESMA's guidance on liquidity stress testing in funds, which has been in force since September 2020 and whose implementation was being finalised in many of the entities analysed, should allow taking into account the results of market stress tests applied to derivatives used to assess the level of liquidity in portfolios.

Liquidity needs related to potential redemptions

Generally speaking, the asset management companies analysed have varying degrees of familiarity with the liability structure of the funds they manage. They may apply stressed redemption scenarios based on historic redemption data and/or on the holdings of the

largest investors. The application of the ESMA guidelines should allow the formalisation of the reconciliation of redemption simulations and portfolio liquidity indicators, as well as the existence of alert thresholds and reporting mechanisms associated with this monitoring. Among the good practices, the regulator noted the adoption of a proactive attitude towards fund holders and distribution networks in the event of financial market stress.

Use of liquidity management tools

Use of these tools is not sufficiently specified in the prospectuses, regulations or articles of association of the funds analysed. The AMF also found that not all funds justify their choice of tools (caps on redemptions or gates, net asset value adjustments or swing pricing, etc). Although the practical arrangements for the mechanisms attached to these tools are set out in procedures, these procedures do not generally specify the criteria for implementing them.

Taking proper account of liquidity risk is essential for UCITS funds. The AMF requests that asset management companies reinforce their procedures, especially for UCITS funds with a particular liquidity risk.

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