Response form for the Consultation Paper on the Guidelines on liquidity stress testing in UCITS and AIFs

1 February 2019

European Securities and Markets Authority

Date: 1 February 2019

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions in Annex I. Comments are most helpful if they:
- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **1 April 2019**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

- Insert your responses to the questions in the Consultation Paper in the present response form.
- Please do not remove tags of the type <ESMA_QUESTION_LST_1>. Your response to each question has to be framed by the two tags corresponding to the question.
- If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.
- When you have drafted your response, name your response form according to the following convention: ESMA_LST_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_LST_ABCD_RESPONSEFORM.
- Upload the form containing your responses, **in Word format**, to ESMA's website (www.esma.europa.eu under the heading "Your input – Open consultations").

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection
Information on data protection can be found at www.esma.europa.eu under the heading Legal Notice.

Who should read this paper?

The main stakeholders to whom these guidelines would apply are managers of UCITS and EU AIFMs as well as EU depositaries overseeing UCITS and EU AIFs. The paper will also be of interest to trade associations, investors and consumer groups relating to UCITS and EU AIFs.

General information about respondent

Name of the company / organisation	MSCI
Activity	Other Financial service providers
Are you representing an association?	☐
Country/Region	International

Introduction

Please make your introductory comments below, if any:

<ESMA_COMMENT_LST_1>
MSCI appreciates the opportunity to offer these comments to the European Securities and Markets Authority ("ESMA") in response to the consultation on draft guidelines on liquidity stress testing in UCITS and AIFs. We support ESMA's goals to establish common guidelines on the stress testing part of the liquidity risk management program of UCITS and AIFs. We thank ESMA for the opportunity to provide our perspective on the proposed guidelines.

MSCI is an independent provider of research-driven insights and tools for institutional investors. We have deep expertise in the areas of risk and performance measurement that is based on more than 40 years of academic research, real-world experience and collaboration with our clients.
Our broad product line supports clients' needs across all major asset classes and provides them with a consistent way of looking at risk and performance from front to middle office. We have a highly flexible business model that enables clients to select the individual products and services they need and integrate them into their own investment processes and methodologies. Our line of products and services includes indexes, analytical models, data, real estate benchmarks and ESG research. We serve 99 of the top 100 largest money managers, according to the most recent P&I ranking.

MSCI is an independent provider with no Asset Management company nor Bank within its corporate structure. MSCI has been actively engaged in research on the subject of liquidity risk management since 2009 and licenses sophisticated liquidity risk analytics to market participants to support both risk management and regulatory compliance activities (e.g., SEC, UCITS, Form PF). MSCI's views on the subject of liquidity risk is the result of a decade long research on the subject, focused on model innovation and regulatory applicability and they have also been informed by the feedback we have received from the asset managers who utilize our liquidity risk management tools.

<ESMA_COMMENT_LST_1>

Q1 : What additional costs and benefits would compliance with the proposed Guidelines bring to the stakeholder(s) you represent? Please provide quantitative figures, where available.

<ESMA_QUESTION_LST_1>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_1>

Q2 : Do you agree with the scope of these Guidelines? Should certain types of funds be explicitly excluded from these Guidelines? Should MMFs remain in-scope of these Guidelines?

<ESMA_QUESTION_LST_2>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_2>

Q3 : Is additional clarity required regarding the scope of these Guidelines? Is additional clarity required regarding the meaning of 'nature, scale and complexity' of a fund? Are there circumstances in which it would, in your view, be inappropriate for a UCITS to undertake LST?

<ESMA_QUESTION_LST_3>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_3>

Q4 : What are your views on when the Guidelines should become applicable? How much time would managers require to operationalise the requirements of these Guidelines?

<ESMA_QUESTION_LST_4>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_4>

Q5 : Do you agree with the proposed approach of setting out a list of Guidelines all funds should follow, and the provision of explanatory considerations to help managers comply with those overarching Guidelines? Do you see merit in including some of the explanatory considerations in the final Guidelines?

<ESMA_QUESTION_LST_5>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_5>

Q6 : Do you agree with the proposed Guidelines? What amendments, if any, should ESMA make to its proposed Guidelines?

<ESMA_QUESTION_LST_6>
We give our high level opinion and suggestions to the guidelines in the answer to this question. We'll go into the details in answering more specific questions later in our response.
As noted in the introductory comments, MSCI supports ESMA's goals to establish common guidelines on liquidity stress testing and agrees most of the guidelines listed in the consultative document.

- Our first comment is related to point c) of Guideline 7, which connects the complexity of the LST model to the complexity of the fund's investment strategy. We believe that the liquidity model's complexity depends much stronger on the asset classes the fund is investing in. Thus, we suggest either explicitly listing other points "the complexity of the LST model, which should account for" part or stating that this is just one example.

- We agree to point b) of Guideline 9 which states that managers should avoid unjustifiable reliance on third parties' LST models. We don't think, however, that this point should be connected to data availability. In practice, many fund managers will use third party liquidity models to conduct their LST since building such a model in-house often proves to be more expensive. The choice to rely on third party models is thus not solely connected to data availability this guideline refers too. We thus suggest ESMA to remove point b) from Guideline 9.
- We agree with the importance of combined asset and liability LST, in fact, we believe that this is the main LST funds should ultimately do. Separate asset and liability side stress tests are merely tools to properly build a combined LST. Since asset side liquidity shocks and extreme redemptions tend to happen at the same time, we suggest to further emphasise the importance of this stress and remove Guideline 14, which suggests that conducting it isn't always appropriate.

<ESMA_QUESTION_LST_6>

Q7 : Do you agree with the proposed explanatory considerations regarding LST of fund assets?

<ESMA_QUESTION_LST_7>
In general, we believe that Section 6's explanatory considerations are sound. We particularly agree with ESMA to give flexibility to fund managers on the details of LST methodology. In the next paragraph, we list our comments related to this Section and indicate which paragraph of the consultative document these comments refer to.

- (General) Our first critical comment is related to multiple references on normal and stressed market conditions. We agree that fund's liquidity risk management programmes should adequately cover both, but the current guidelines' topic is stress testing and it's unclear to us what stress testing normal conditions means. For example, what should be the difference between a historical stress test applying the shocks to the European debt crisis on normal or stressed market conditions? We believe that ESMA should either further explain what normal conditions mean in the stress testing context or remove references to the normal condition and acknowledge that stress testing is by definition concerned with stressed market conditions.
- (Paragraph 25) We don't agree with the convex relationship between the transaction cost and trade size, most of the literature suggests that as trade size increases, the increase in transaction costs slows down, thus the relationship is concave. We agree to ESMA that transaction costs can be large for small, odd-lot trades, but we believe that modelling this phenomenon isn't necessary in a sound liquidity risk management program. The ultimate goal of the LST is to make sure fund managers understand their ability to meet redemptions in stressed market conditions and it's highly unlikely that too small trades will be a material problem in these situations. We suggest to
    - Remove any reference to the shape of the trade size – transaction cost function
    - Explicitly mention that stress testing should consider the effect of liquidating large positions quickly
- (Paragraph 28) We believe that historical stress testing can be useful, but we suggest to emphasize even further the limitations of this type of stress tests, especially in markets where the market structure changed tremendously over the last years. For example, applying observed liquidity stresses during the internet/dotcom crisis to today's fixed income markets isn't very useful since the market changed fundamentally in the past 18 years.
- (Paragraph 30) This paragraph suggests that the average daily traded volume (ADV) is some kind of natural limit to the amount a fund manager can expect to trade in any asset in a single day. We strongly believe that ADV is not a good risk measure and ESMA shouldn't promote its usage. For example, in case of assets which don't trade every day (almost the entire fixed income universe), almost all the trades which do happen are larger than the long term ADV. We suggest to remove the reference to ADV from this paragraph.
- (Paragraph 32-33) See answer to Q10.

<ESMA_QUESTION_LST_7>

Q8 : What are your views on the requirement to undertake reverse stress testing, and the use of this tool?

<ESMA_QUESTION_LST_8>
We support the usage of reverse stress testing and agree with ESMA on its potential benefits.
<ESMA_QUESTION_LST_8>

Q9 : Do you see merit in providing further considerations for managers on the use of data relevant to asset liquidity, particularly in circumstances when data is scarce?

<ESMA_QUESTION_LST_9>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_9>

Q10 : Do you agree with ESMA's wording regarding the asset liquidation method used in the LST model? How would you describe the asset liquidation method used by you or the managers you represent?

<ESMA_QUESTION_LST_10>
We support ESMA in bringing closer the asset liquidation method used in LST to the methods used by a fund's portfolio managers in reality. We agree that this exercise can potentially provide valuable insights into the liquidity of the fund. We propose, however, to explicitly require funds to perform LST using 'pro-rata' liquidation as well, especially for stress tests related to liquidation costs. To continue the example in paragraph 33, let's consider a hypothetical fund investing 20% of assets in Treasuries while 80% in illiquid real estate. If the LST allows the usage of Treasuries in the short term to cover sudden large redemptions and also allows a long time for portfolio managers to rebalance the portfolio, all stress tests done with this strategy will show a very rosy picture of the liquidation costs of this fund, even during stressed market conditions. While this might be the case (i.e. the 20% Treasury buffer might be indeed enough), we believe that there are other insights a portfolio manager could learn about potential transaction costs by assuming a forced pro-rata liquidation. Using pro-rata is less important for stress tests focusing on the liquidation time, since in that exercise, a single illiquid position could become the bottleneck and cause unrealistically long liquidation horizons for the entire portfolio.
<ESMA_QUESTION_LST_10>

Q11 : Do you agree with ESMA's wording regarding 'second round effects'? What is your current practice regarding modelling 'second round effects'?

<ESMA_QUESTION_LST_11>
We agree with the definition and potential importance of second round effects, but point out that modelling such effects are significantly harder than any other requirement in the consultative document. To model these effects, fund managers should have assumptions on the behaviour of other funds and investors in general, which assumptions would be very hard, if not impossible, to validate.
<ESMA_QUESTION_LST_11>

Q12 : What are your views on the considerations on difficult to model parameters, such as price uncertainty? What is your current practice concerning this issue?

<ESMA_QUESTION_LST_12>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_12>

Q13 : Do you agree with ESMA's considerations on LST in funds investing in less liquid assets? What amendments should be made to the proposed wording? Do you think that ESMA should outline additional and/or specific Guidelines to be made in any other fund or asset types, such as ETFs?

<ESMA_QUESTION_LST_13>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_13>

Q14 : Do you agree with the considerations regarding LST on items on the liabilities side of a fund's balance sheet?

<ESMA_QUESTION_LST_14>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_14>

Q15 : Do you agree with the considerations specifying the LST of redemptions and other types of liabilities may need to be considered distinctly, given a fund could potentially limit redemptions but not other sources of liquidity drain?

<ESMA_QUESTION_LST_15>
We agree with ESMA on this point, but point out another difference between redemptions and other types of liabilities: any effect of the latter will be borne by all investors and thus fairness between redeeming and remaining investors is not a problem for other liabilities.
<ESMA_QUESTION_LST_15>

Q16 : Do you agree with the requirement to reverse stress test items on the liabilities side of the fund balance sheet?

<ESMA_QUESTION_LST_16>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_16>

Q17 : Do you agree with the requirement to incorporate investor behaviour considerations into the LST model 'where appropriate'? Are there cases which you believe it would not be appropriate, and should these be detailed in these Guidelines?

<ESMA_QUESTION_LST_17>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_17>

Q18 : What do you think about ESMA's Guideline stating that managers should combine LST results on both sides of the balance sheet?

<ESMA_QUESTION_LST_18>
As we pointed out in previous answers, we believe that conducting these stress tests in a combined way should be a mandatory part of any sound liquidity risk management program.
<ESMA_QUESTION_LST_18>

Q19 : What are your views on ESMA's Guideline that aggregated LST should be undertaken where deemed appropriate by the manager?

<ESMA_QUESTION_LST_19>
We think that it's very hard to imagine a fund where it's not appropriate to conduct this type of LST. For most funds, asset and liability side shocks will tend to happen at the same time and the LST exercise should reflect that.

<ESMA_QUESTION_LST_19>

Q20 : What is your experience of performing aggregated LST and how useful are the results?

<ESMA_QUESTION_LST_20>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_20>

Q21 : What are your views on ESMA's considerations concerning the use of LST during a fund's lifecycle?

<ESMA_QUESTION_LST_21>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_21>

Q22 : What is your experience of the use of LST in determining appropriate investments of a fund?

<ESMA_QUESTION_LST_22>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_22>

Q23 : In your view, has ESMA omitted any key uses of LST?

<ESMA_QUESTION_LST_23>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_23>

Q24 : Do you agree with ESMA's Guideline that LST should be undertaken in all cases annually, but that it is recommended to undertake it at least quarterly, unless a different frequency can be justified? What is the range of frequency of LST applied on funds managed by stakeholder(s) you represent?

<ESMA_QUESTION_LST_24>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_24>

Q25 : Should ESMA provide more prescriptive Guidelines on the circumstances which can justify a more/less frequent employment of LST?

<ESMA_QUESTION_LST_25>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_25>

Q26 : Do you agree that LST should be employed outside its scheduled frequency (ad-hoc) where justified by an emerging/imminent risk to fund liquidity?

<ESMA_QUESTION_LST_26>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_26>

Q27 : What are your views on the governance requirements regarding LST?

<ESMA_QUESTION_LST_27>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_27>

Q28 : Should more information be included in the UCITS RMP and AIF RMP?

<ESMA_QUESTION_LST_28>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_28>

Q29 : Do you have any views on how managers which delegate portfolio management can undertake robust LST, independently of the portfolio manager, particularly when the manager does not face the market?

<ESMA_QUESTION_LST_29>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_29>

Q30 : Do you agree with the proposed Guideline for depositaries on carrying out their duties regarding LST?

<ESMA_QUESTION_LST_30>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_30>

Q31 : In your experience do depositaries review the UCITS RMP and AIF RMP as a matter of course?

<ESMA_QUESTION_LST_31>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_31>

Q32 : Do you see merit in ESMA publishing further guidance on the reporting of results of liquidity stress tests? If so, in your view how should ESMA require that results be reported?

<ESMA_QUESTION_LST_32>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_LST_32>