Liquidity management advisory

Our proposition for your benefit.

www.kpmg.lu

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The fund industry is evolving rapidly. Regulators' increased scrutiny and on-site visits demand that all market participants be at the top of their game to minimize the risk of regulatory intervention, as well as cultural or reputational damage.

We strongly believe that communication and exchange of ideas are vital to understand, reflect upon and anticipate current developments.

With this in mind, we would be delighted to set up an exchange meeting with you to explore the wider aspects of liquidity management.

Looking forward to finding out how we can best support you.

Sincerely,

Alan Picone
Partner

Liquidity management matters

Regulatory scrutiny levels are rising

In February and March 2020, the coronavirus crisis jolted the world and its economy like nothing before. In only two weeks, stock markets plunged by nearly 40% — an event that will go down as one of the largest stock market crashes in history.

To provide vital support to businesses during the Covid-19 pandemic, governments had to react quickly with targeted measures.

Asset management companies were confronted with large redemption requests, mainly from institutional investors, and the CSSF allowed swing pricing/dilution levy factors to be applied beyond the maximum percentage given in prospectuses.

But 2019 was already a rocky road for financial markets — which, overall, have weathered worrying signs like micro crystallization of liquidity risks. For example, the flagship fund managed by Neil Woodford was suspended in June 2019 by the FCA due to its highly-concentrated portfolio of illiquid and unlisted assets. And, six months later, M&G suspended two of its property funds due to redemption concerns.

What are the consequences?

While scrutiny of fund liquidity is nothing new, having been thoroughly debated at a global level already, these events have lit up liquidity risk on regulators' radars more than ever before. In the current volatile market conditions, the liquidity management arrangements of management companies are being tested in real-time — and must be sufficiently robust to cope with unprecedented situations.

What about Luxembourg?

Since 2019, the Luxembourg regulator has increased its vigilance on liquidity-risk arrangements through supervision and inspection programs — which are only set to continue.

What's next?

As regulatory focus is on robust liquidity management governance frameworks, it is essential to demonstrate there is a proper liquidity risk measurement (LRM) environment in place. Therefore, ManCos of open-ended funds must first formalize a robust LRM framework before establishing its daily operation's application and effectiveness.

Regulatory scrutiny on liquidity management will only increase, with 2020 set to be a major milestone. Therefore, asset managers must revisit and strengthen their liquidity management framework and governance.

Market perspective and regulatory background

As of 2020, the European Union's market watchdogs kicked off coordinated checks to ensure asset managers are not flouting liquidity rules.

In January 2020, Europe's market watchdog ESMA announced that it agreed with national competent authorities to "assess simultaneously whether market participants in their jurisdictions adhere to the rules on liquidity risk management in their day-to-day business". And, that national regulators will share knowledge and experiences with ESMA to "ensure supervisory convergence in the way they supervise liquidity risk management".

On 20 December 2019, the CSSF released Circular 19/733 that immediately entered into force. It refers to the International Organization of Securities Commission's (IOSCO) recommendations and good practices on liquidity risk management for undertakings for collective investment (UCIs). The Circular aims to apply these IOSCO recommendations to certain entities managing open-ended UCIs, as defined in Section I.

Previously, on 2 September 2019, ESMA published the final guidelines on liquidity stress testing (LST) in UCITS and AIFs, following consultations initiated in April 2019. These final guidelines will take effect from 30 September 2020 onwards.

Liquidity management advisory

Whatever your setup, we have the tools and expertise to assist you.

Our service at a glance

Risk reporting

- Risk reporting solutions that are compliant with CSSF Circular 19/733.

Framework assessment services

- Regulatory readiness analysis.
- Health check analysis.
- Regulatory gap analysis.
- Operational effectiveness analysis.
- Peer benchmarking analysis.
- Specific document review.

Liquidity risk modeling

- Tailor-made LRM model design.
- Existing model adaptation to various fund strategies.
- Pragmatic key risk indicator setup.
- Model validation and review.

Operating model design services

- Effective liquidity management operating model design from scratch.
- Liquidity profiling procedures and related documents design.
- Gap remediation plan design.

Training and workshops

- Tailored technical workshops.
- Regulatory updates.
- Training with KPMG certifications.

Implementation services

- Target operating model implementation.
- Policies and procedures creation.
- Liquidity risk model implementation.

Liquidity contingency measures

During turbulent times, several measures can be applied to safeguard the interests and protection of investors; maintain the order and robustness of UCIs and markets; and help reduce systemic risk — all of which support financial stability.

Swing pricing or dilution levy is designed to protect long-term shareholders from dilution caused by trading costs resulting from subscription and redemption activity in the fund by other shareholders' activity. A fund that chooses swing pricing will adjust its NAV by a specified amount — the swing factor — once the level of net purchases into or net redemptions from the fund exceeds a percentage of the fund's NAV, known as the swing threshold. Swing price policies and procedures must specify the process used to determine the fund's swing factor and swing thresholds — and establish an upper limit of the swing factor used.

NAV suspensions are exceptional measures that temporarily protect a fund against uncertain or adverse conditions. The suspension is only allowed for reasons that are clearly beyond the fund's control. Reasons like closed markets or prices that do not reflect the plausible prices of assets to dispose on the market can lead to NAV suspension being considered as an appropriate measure.

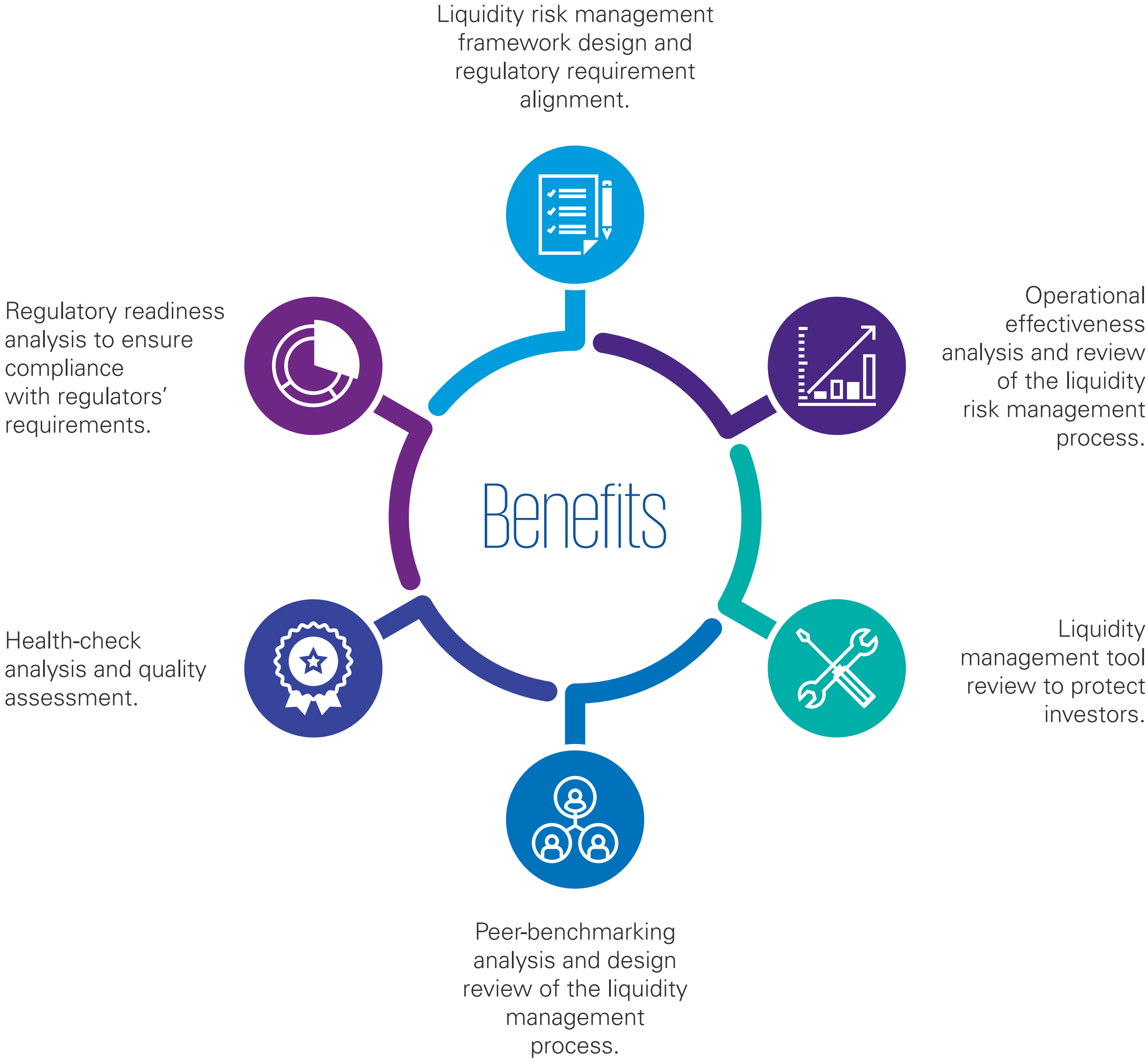
And, going a step further, it is worth developing **liquidation strategies** — however, these might only be considered as a last resort as they involve selling the fund's assets and shuttering the fund.

The above measures are only a few examples of the liquidity contingency options available. But whatever measures are decided upon, it is always crucial to properly disclose to and share information with the different stakeholders involved, i.e. investors or national competent authorities (NCA). Disclosures in the funds' prospectuses provide transparency to investors and prevent unpleasant surprises in turbulent times.

Liquidity management – regulatory advisory

The specifics

Regulation is driven by an array of varying agencies and agendas, including ESMA, IOSCO and national competent authorities. To comply with these different sets of regulatory requirementsws vital to establish an all-encompassing liquidity management framework.



Liquidity management – strategy advisory

Strategy is key

Before the funds' design phase is launched, an effective liquidity risk management process must be in place that reflects the funds' investment strategy, liquidity profile and redemption policy.

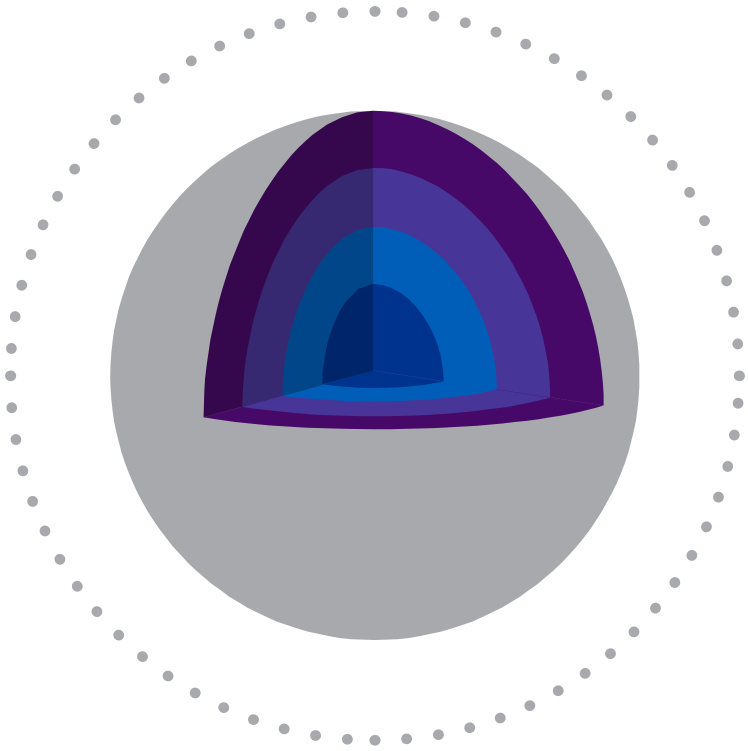
1. Definition of relevant data and factors to identify possible risks, especially potential future liabilities and redemptions.
2. Integration of the liquidity management strategy into the investment decision process.
3. Definition of liquidity management tools e.g. limit, defer or suspend redemption rights.
4. Testing and evaluation of the liquidity management strategy including stress-testing recommendations.
5. Introduction of investor communication channels and set up of sound contingency plans.

Liquidity management — operating model

Whatever your setup, we have the tools and expertise to assist you.

Governance plays an essential role in the liquidity risk management process — even the most sophisticated liquidity modeling and perfectly predicted cash flows can be undone by a lack of effective oversight or controls to analyze the data produced.

Design of effective liquidity management operating models from scratch.



Implementation of target operating models.

Design of liquidity profiling procedures and related documents.

Liquidity risk stress testing

Whatever your setup, we have the tools and expertise to assist you.

Stress testing of fund liquidity is a key focus of regulators, being generally recognized as a pivotal factor for effective risk management. These tests put the following elements through their paces:

Liquidity risk reporting

Whatever your setup, we have the tools and expertise to assist you.

KPMG Luxembourg's tried-and-tested methodologies can support you in all areas of liquidity risk reporting and stress testing.

Open-ended funds

Application of different stress configurations to different sub-funds:

- Historical scenarios based on pertinent parameters during stress periods.
- Hypothetical scenarios based on investment strategy and investor profile.

Application of portfolio-slicing and waterfall approaches to ensure compliance with investment limits in distressed situations.

Enrichment of instruments covered by the model: ETF, UCITS and AIFs.

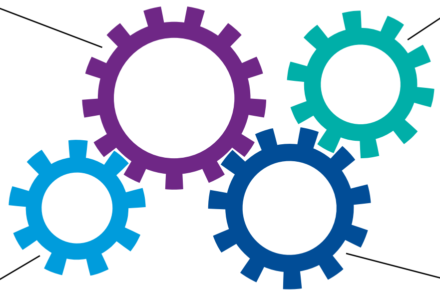
Analysis of historical redemption patterns and their statistical distribution.

Estimation of potential margin-liquidity risk through specific market stress tests on derivatives.

Closed-ended, leveraged funds

Bespoke solutions based on the nature of the leverage.

Simulation of refinancing risks, e.g. by assuming financed assets cannot be sold at the envisaged date.



Simulation of cash-in and outflows/liquidity ratios in distressed situations that assess the impact on distances-to illiquidity.

Simulation of impact of credit events that trigger covenants entering into effect.

Liquidity risk management curriculum

A tailored liquidity risk management curriculum to tackle an increasingly complex regulatory environment

To help market participants address their numerous liquidity risk management challenges, we offer a training curriculum that covers all relevant areas from an audit and risk management perspective.

This curriculum is fully modular, allowing you to tailor the training to your specific needs and requirements. A dedicated team of experienced professionals will provide an in-depth view of the relevant regulatory provisions, methodologies and market best practice.

Introduction

Regulatory background in Luxembourg and Europe

Curriculum modules

The story of liquidity

- The failure of LTCM
- Liquidity crisis
- The Woodford case
- Lessons learnt but still not understood

CSSF Circular 19/733

- Design process of UCIs
- Day-to-day liquidity management of UCIs
- Contingency planning

Liquidity stress testing

- Importance of LST
- Impacts and expected implementations
- Asset and liability perspectives

Gap analysis

- Assessment of as-is situation
- Identification of gaps and remedial actions
- Workshops
- Benchmarking

Contact us

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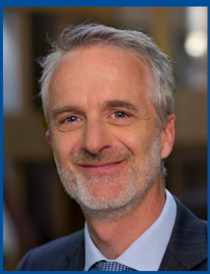

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