Liquidity Stress Testing under new ESMA regulations

The European Securities and Markets Authority (ESMA) published their final set of Guidelines on Liquidity Stress Testing (LST) in September 2019. **These Guidelines are set to come into force from 30 September 2020.** There are several critical areas of focus which we have outlined below:

### Focus areas

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<th>Focus areas</th>
<th>LST considerations</th>
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| **Who is in the scope?** | - Guidelines apply to **all UCITS and AIFs** (including Exchange Traded Funds (ETF) and Money Market Funds (MMF)).  
- Existing regulations and ESMA guidelines applying exclusively to MMFs shall prevail over the LST Guidelines. |
| **Overarching principles** | - **Principles-based approach:** LST should be adapted appropriately to each fund’s characteristics; these include frequency of scenarios employed, investor behaviour assumptions, model complexity and ETF specifications.  
- **Independence:** LST should be performed independently from front-line functions such as portfolio management. |
| **Requirements** | - LST should be properly integrated into the fund’s **risk management framework** and documented in an **LST policy**.  
- Model managers should design suitably **robust LST models** for measuring both the liquidity of assets and the fund’s liabilities.  
- LST managers should have a strong understanding of the fund’s liquidity risks, and overall liquidity profile. |
| **Frequency of LST** | - LST must be carried out **at least annually**. However quarterly exercises are recommended as best practice.  
- **Individual fund characteristics** may **increase/decrease the frequency** of the recommended regular LST.  
- **Ad hoc analysis** should also be undertaken should the LST manager identify a material risk requiring timely assessment. |
| **Scenarios** | - LST should employ both **hypothetical and historical** scenarios and should also consider low-probability, high impact scenarios where relevant.  
- **Reverse Stress Testing (RST)** should also be employed where appropriate.  
- RST should be used to simulate how assets would be liquidated in an **extreme market event**, and the consequences of such an event on the overall liquidity profile. |
| **Benefits of LST** | - LST allows funds to:  
  - **assess the impact** of market stresses on their overall liquidity profile;  
  - **anticipate activity** in stressed market conditions; and  
  - **identify potential vulnerabilities**.  
- **Early adoption and integration** of LST will allow funds test the effectiveness and robustness of their LST framework and ensure integration into the risk framework ahead of the September 2020 deadline. |
Key Regulatory Priorities

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<th>Priority area</th>
<th>Description</th>
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| Framework & policy | Regulators expect to see LST:  
  – Fully integrated into the existing risk management framework;  
  – Subject to robust governance and oversight, (including clearly defined reporting and escalation procedures); and  
  – Performed independently from front-line functions.  
The Regulator will also expect to see LST documented in an LST policy, which is subject to periodic review. |
| Scenarios & data | Regulatory expectations are that LST should:  
  – Be tailored to the specificities of each fund’s portfolio composition, investor behaviour, risk appetite etc.  
  – Employ both historical and hypothetical scenarios;  
  – Apply RST techniques, where appropriate; and  
  – Incorporate low-probability, high-impact scenarios.  
The LST Manager must respond to limitations related to the availability of data through using expert judgement and avoiding optimistic assumptions. |
| LST models | Regulators will expect any models used for LST to include:  
  – All relevant risk factors;  
  – A suitable range of scenarios;  
  – Monitoring of outputs and indicators;  
  – Reporting of LST results to senior management; and  
  – How the LST results are used in decision making. |

How can KPMG support you?

**Framework & policy**
- Designing and integrating a liquidity risk management framework.
- Performing gap analysis on your existing framework, including governance, reporting and oversight procedures.
- Drafting an LST policy, based on the 12 principles in the ESMA LST Guidelines in combination with our knowledge of the industry.
- Performing gap analysis on your existing LST policy.

**Scenarios & data**
- Performing data quality assessments and/or remediation on data sets underpinning historical scenarios;
- Developing scenarios to be employed in the LST model;
- Developing RST parameters;
- Reviewing existing scenarios / RST, providing feedback on the appropriateness of the number of scenarios, type/severity, assumptions and/or inclusion of expert judgement.
- Performing benchmarking and independent assurance over the assumptions made by management.

**LST models**
- Developing an LST model appropriate to your fund characteristics;
- Model development based on principles in the LST Guidelines and industry best practice.
- We apply both quantitative techniques (data analysis, performance testing) and qualitative analysis (reg requirements, documentation, governance)
- Developing a reporting/output solution.
- Assessment of existing LST models, and/or reporting processes including validation where required.

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