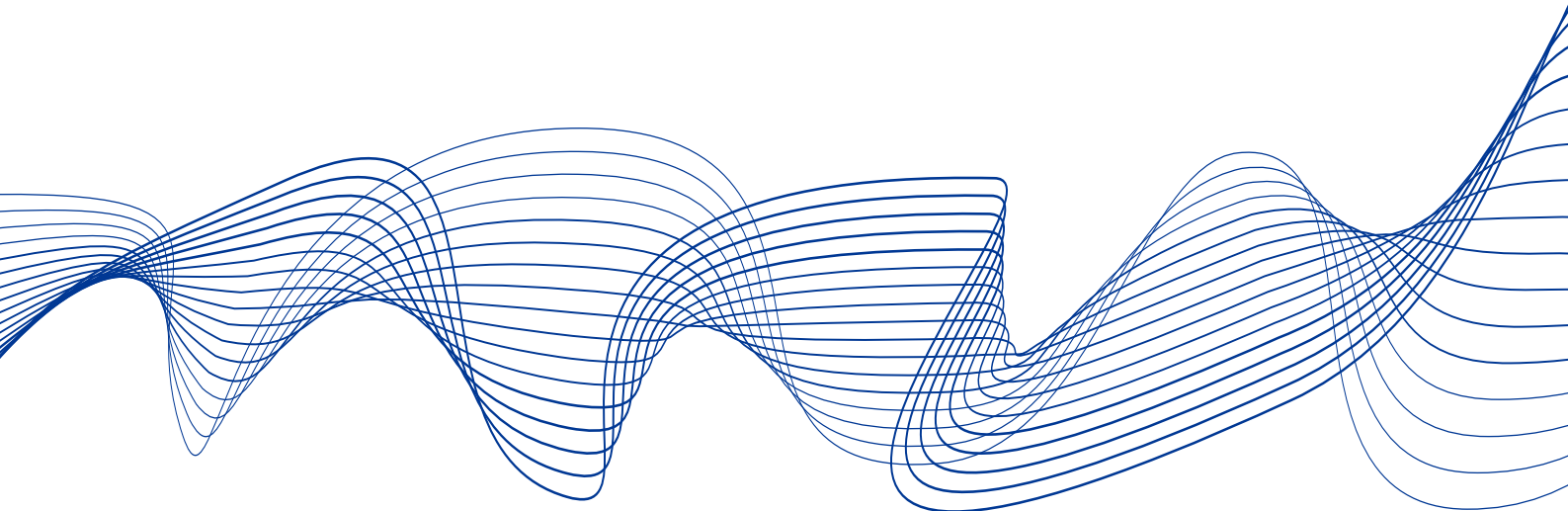


Compliance Report

September 2021

Recommendation of the European
Systemic Risk Board of 6 May 2020
on liquidity risks in investment
funds (ESRB/2020/4)



ESRB
European Systemic Risk Board
European System of Financial Supervision

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1 Introduction

This compliance report assesses the implementation of the Recommendation of the European Systemic Risk Board of 6 May 2020 on liquidity risks in investment funds (hereinafter the “Recommendation”)¹ as of June 2021.

Recommendations issued by the ESRB are not legally binding but are subject to an “act or explain” regime in accordance with Article 17 of the ESRB Regulation². This means that the addressees of recommendations are subject to an obligation to inform the Parliament, the Council, the Commission and the ESRB of the actions they have taken to comply with recommendations or to provide adequate justification for their inaction.

The European Securities and Markets Authority (ESMA) is the sole addressee of this Recommendation, which aims to address the potential systemic vulnerabilities stemming from liquidity mismatches in investment funds.

Under Section 2(3) of the Recommendation, ESMA was requested to submit a follow-up report on the actions undertaken in response to the Recommendations or to substantiate any inaction by 31 October 2020.

The assessment of compliance with Recommendation 2020/4 was carried out by an Assessment Team consisting of eight assessors, including one Chair, endorsed by the Advisory Technical Committee (ATC) of the ESRB, and was supported by ESRB Secretariat staff (see Annex I of this Report for details on the Assessment Team)³. The assessment is based on the report published by ESMA in November 2020⁴ and subsequent interactions with ESMA.

The assessment was conducted by duly taking into account:

- the objectives of the Recommendation;
- the principles underpinning the “Handbook on the assessment of compliance with ESRB Recommendations” of April 2016⁵ (hereafter the “Handbook”);
- the implementation standards prepared by the Assessment Team, which specify the grade to be awarded for each key element of the Recommendation on the basis of the objectives of the Recommendation (see Annex II for details of the implementation standards);

¹ Recommendation of the European Systemic Risk Board of 6 May 2020 on liquidity risks in investment funds (ESRB/2020/4) (OJ C 200, 15.6.2020, p. 1).

² Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (OJ L 331, 15.12.2010, p. 1).

³ The members of the Assessment Team also carried out the assessment of compliance with Recommendations C and E of ESRB Recommendation 2017/6 on liquidity and leverage risks in investment funds.

⁴ European Securities and Markets Authority (ESMA), “Report – Recommendation of the European Systemic Risk Board on liquidity risks in investment funds”, 12 November 2020 (ESMA 34-39-1119).

⁵ ESRB Handbook on the assessment of compliance with ESRB recommendations, April 2016 https://www.esrb.europa.eu/pub/pdf/other/160502_handbook.en.pdf?ad3639a90ee362a34bdc71e2faa56e2a



- the principle of proportionality.

Overall, the Assessment Team, while carrying out the assessment of ESMA's actions, observed full compliance with the Recommendation.

This compliance report is structured as follows. Part I recalls the policy objectives of the Recommendation. Part II summarises the methodology set out in the Handbook, which establishes the procedure for assessing compliance with ESRB recommendations, and presents the implementation standards drafted by the Assessment Team and used to assess compliance by the addressees with the respective recommendations. Part III consists of the Assessment Team's evaluation of ESMA's compliance with the Recommendation.



2 Policy objectives

The sharp fall in asset prices observed at the onset of the coronavirus (COVID-19) pandemic was accompanied by significant number of redemption requests to certain investment funds and a significant deterioration in financial market liquidity. While market conditions have subsequently stabilised, significant uncertainty remains concerning the macrofinancial outlook and the preparedness of certain open-ended investment funds for future adverse liquidity shocks.

The Recommendation aims at enhancing the preparedness of investment funds to respond to potential future adverse shocks that could lead to a renewed deterioration in financial market liquidity and potentially worsen financial stability conditions in the Union.

The ESRB has identified two types of investment funds as particularly high priority areas from a financial stability perspective, namely open-ended funds with significant exposures to corporate debt and open-ended funds with significant exposures to real estate. Any future redemption pressure on these funds could result in quick sales of less liquid assets, thereby contributing to a deterioration in liquidity conditions and an increase in valuation uncertainty. This could also have adverse spillover effects on other financial institutions that have exposure to these assets.

2.1 Content and structure of Recommendation A

RECOMMENDATION A

Coordinating supervisory engagement with investment funds to assess their preparedness

ESMA is recommended to:

1. **coordinate with the national competent authorities to undertake a focused supervisory exercise with investment funds that have significant exposures to corporate debt and real estate assets** to assess the preparedness of these two segments of the investment funds sector for potential future adverse shocks, including any potential resumption of significant redemptions and/or an increase in valuation uncertainty; and
2. **report to the ESRB on its analysis and on the conclusions** reached regarding the preparedness of the relevant investment funds.

2.2 Implementation

The Recommendation is intended to cover open-ended investment funds that have significant exposures to corporate debt and real estate assets. It also aims to take into consideration the principle of proportionality, with regard to its objective and content.

The annexes to the Recommendation further specify the criteria that ESMA is expected to comply with.



3 Methodology

Article 17 of the ESRB Regulation charges the ESRB with monitoring the compliance of addressees with ESRB recommendations. To this effect, and pursuant to Article 20 of the ESRB Rules of Procedure⁶, the ESRB assesses the actions undertaken and justifications communicated by the addressees of ESRB recommendations in accordance with the “act or explain” mechanism described in Article 17 of the ESRB Regulation, whereby the addressee of a recommendation can either (i) take action in response to a recommendation, or (ii) adequately justify any inaction. The ESRB thus analyses the information provided by addressees and assesses whether the action taken duly achieves the objective of the recommendation, or whether the justification provided for inaction is sufficient. This analysis results in a final compliance grade being assigned to each addressee, reflecting the level of implementation by the relevant addressee.

3.1 Grading methodology

In order to arrive at a single grade per recommendation a four-step grading methodology was employed, in line with the ESRB Handbook. Such a methodology is necessary to ensure full transparency of the single overall compliance grade and a high level of objectivity in the entire assessment process, while still allowing room for high-quality expert judgement, which can easily be identified and reviewed to understand the rationale behind the allocation of particular overall grades.

Step I - When assessing compliance with the Recommendation, the implementation of each sub-recommendation is graded in accordance with the established implementation standards. The grading can be:

- fully compliant/largely compliant/partially compliant/materially non-compliant/non-compliant, in the case of action;
- sufficiently explained/insufficiently explained, in the case of inaction;
- not applicable.

The grading scale for action is as follows:

- Fully compliant (FC): an addressee complies entirely with the requirements;
- Largely compliant (LC): requirements have been met almost entirely and only negligible requirements remain to be implemented;

⁶ Decision of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board (ESRB/2011/1) (OJ C 58, 24.2.2011, p.4).



- Partially compliant (PC): the most important requirements have been met; certain deficiencies affect the adequacy of the implementation, without resulting in a situation where the given recommendation has not been acted upon;
- Materially non-compliant (MN): the requirements have been fulfilled to a degree, resulting in a significant deficiency in the implementation;
- Non-compliant (NC): almost none of the requirements have been met, even if steps have been taken towards implementation.

The grading scale for inaction is as follows:

- Sufficiently explained (SE): a complete and well-reasoned explanation for the lack of implementation has been provided. If one or more of the sub-recommendations are intended to address a particular systemic risk that does not affect a particular addressee, such justification/explanation may be considered sufficient;
- Insufficiently explained (IE): the explanation given for the lack of implementation is not sufficient to justify the inaction;

Step II - Compliance grades for every sub-recommendation are converted into a numerical grade (see the table below). These numerical grades are then weighted and aggregated into a single numerical grade for each recommendation.

Compliance grade	Numerical grade
Fully compliant (FC)	1
Largely compliant (LC)	0.75
Partially compliant (PC)	0.5
Materially non-compliant (MN)	0.25
Non-compliant (NC)	0
Sufficiently explained (SE)	1
Insufficiently explained (IE)	0
Not applicable (N/A)	N/A

Step III - The numerical grades for each sub-recommendation are then weighted and aggregated into a single numerical grade for the entire Recommendation.

Step IV - Finally, the overall compliance grade is determined by converting the single numerical grade for the entire Recommendation into a final grade for compliance using the conversion table below.



Compliance grades	Numerical grades
Action	
FC	0.9 - 1
LC	0.65 - <0.9
PC	0.4 - <0.65
MN	0.15 - <0.4
NC	0 - <0.15

The level of compliance is finally expressed in a colour-coded form:

Positive grades	Mid-grade	Negative grades
Fully compliant (FC) – Actions taken fully implement the Recommendation		Materially non-compliant (MN) – Actions taken only implement a small part of the Recommendation
Largely compliant (LC) – Actions taken implement almost all of the Recommendation	Partially compliant (PC) – Actions taken only implement part of the Recommendation	Non-compliant (NC) – Actions taken are not in line with the nature of the Recommendation
Inaction sufficiently explained (SE) – No actions were taken but the addressee provided sufficient justification		Inaction insufficiently explained (IE) – No actions were taken and the addressee did not provide sufficient justification



3.2 Principles of fairness, consistency and transparency

While conducting the assessment, the Assessment Team analysed the content/substance of the actions taken by the addressee to assess the extent of compliance with all of the elements of the Recommendation.

To ensure a fair analysis, the Assessment Team created implementation standards against which the responses submitted by the addressee were assessed (see Annex II).

The establishment of these implementation standards was based on the requirements for the Guidelines on liquidity risks in investment funds and follows the key elements of Recommendation A:

- **Sub-recommendation A(1) - Coordinate a supervisory exercise with the National Competent Authorities (NCAs) on investment funds that have significant exposures to corporate debt.** Assess and report on their preparedness to address potential future adverse shocks
- **Sub-recommendation A(2) - Coordinate a supervisory exercise with the NCAs on investment funds that have significant exposures to real estate assets.** Assess and report on their preparedness to address potential future adverse shocks.

With regard to the assessment of proportionality, the Assessment Team examined ESMA's "Report – Recommendation of the European Systemic Risk Board on liquidity risks in investment funds" (34-39-1119 – the "ESMA Report") that presents five priority areas identified to enhance the preparedness of funds that have significant exposures to corporate debt and real estate assets for potential future adverse shocks. ESMA prepared a template for NCAs, with guidance on how to fill it in, in order to collect the information necessary to finalise this Report. ESMA submitted its final Report on November 12, 2020, while the completed template used by NCAs to report data to ESMA was submitted on July 30, 2020.

When conducting the assessment, the Assessment Team agreed not to take into account external sources in the grading of the addressee, apart from the information provided to the ESRB. In this vein, the Assessment Team scrutinised the information provided in order to analyse the reliability of the argumentation and hence to provide a fair valuation for the addressee.

The Assessment Team has been consistent in its evaluation of ESMA's compliance, including a regular exchange either through meetings or through written procedures amongst members. This consistency especially applies to the sequencing of the assessments process and the distribution of workload amongst members.

The Assessment Team shared the first evaluations of the addressee among the members involved and the remaining members had the opportunity to comment and also participate as second assessors in the evaluation of the compliance. Transparency has been ensured through exchange of documentation and control mechanisms.



3.3 Principle of proportionality

In line with EU legislation, and in accordance with Section 2, point 2(1)(a) of the Recommendation, due regard should be paid to the principle of proportionality, taking into account the objective and the content of the Recommendation. The key relevance of the principle of proportionality required the Assessment Team to examine whether ESMA's Guidance provides a clear reference to the proportion of management companies with a significant volume of assets that have adopted the liquidity management tools and to what extent fire sales by a material proportion of funds could move asset prices, likely contributing to the build-up of systemic risks and potentially affecting financial stability. The Assessment Team decided not to include proportionality as a stand-alone grade in the implementation standards and assessed it in conjunction with the other implementation criteria for each one of the sub-recommendations. This was done on the grounds that this principle has been clearly and explicitly communicated to the addressee.

ESMA has specifically referred to the principle of proportionality on a number of occasions. This is stipulated in the "Report on the ESRB recommendation on liquidity risks in funds", whereby ESMA and NCAs agreed on specific selection criteria for identifying the investment funds in the Union that have particularly large exposures to corporate debt and real estate markets and that are particularly important from a macroprudential perspective.

Given the scope of the Recommendation (EU open-ended investment funds), ESMA's Investment Management Standing Committee (IMSC) considered it appropriate to exclude money market funds (MMFs). At the same time, ESMA's IMSC considered it appropriate to include exchange traded funds (ETFs) to achieve a more complete picture of EU investment funds' overall exposure to corporate debt.



4 Assessment

4.1 Recommendation A: Coordinating supervisory engagement with investment funds to assess their preparedness

4.1.1 **Sub-recommendation A(1). Coordinate a supervisory exercise with the NCAs on investment funds that have significant exposures to corporate debt. Assess and report on their preparedness to address potential future adverse shocks.**

ESMA provided the ESRB with an assessment of the preparedness of corporate bond funds, including the compliance criteria outlined in the Recommendation:

Identification of and engagement with investment funds with large exposures to corporate debt markets also taking into account other characteristics, such as redemption frequency and/or the degree of leverage: (FC)

ESMA conducted the work within the IMSC, which includes Member States' financial market authorities. They agreed on the scope and the criteria for selecting a sample of funds, a common methodology, a questionnaire to be addressed to the management companies and a template to be used by NCAs to report the results of their assessments and collection of data/information.

ESMA describes the criteria used for the identification of the sample of investment funds with significant exposures to corporate debt in Chapter 3 (Scope of the assessment, p. 11-13), and gives further details on the identified funds in Section 5.1 (pp. 21-22). ESMA and the NCAs agreed on the following selection criteria: open-ended corporate debt funds are included if their exposure to corporate debt exceeded €1 billion at the end of 2019 or as of 30 June 2020. Fund-of-funds and MMFs are excluded, ETFs are included. NCAs were responsible for collecting data regarding undertakings for collective investment in transferable securities (UCITS) and alternative investment fund (AIFs) domiciled in their respective country and satisfying the size criteria. Sample coverage is therefore measured by comparing sample funds' exposure to corporate debt with the exposure of all funds to corporate debt.

The methodology chosen by ESMA and the NCAs appropriately addresses the issue of proportionality. Given the scope of the Recommendation (EU open-ended investment funds), ESMA's IMSC considered it appropriate to exclude MMFs. Also, ESMA's IMSC considered it appropriate to include ETFs to achieve a more complete picture of EU investment funds' overall exposure to corporate debt.

Assessment of the preparedness of the corporate bond funds identified to address potential future redemption and/or valuation uncertainty shocks: (FC)



This assessment was conducted by considering:

- the fund behaviour at the onset of the COVID-19 pandemic, based on the following information: (i) the level of redemptions seen at the onset of the COVID-19 pandemic, when redemptions from a range of corporate bond funds were elevated; (ii) how liquidity management tools were used at the time, including the specific tools activated by different fund types; and (iii) what types of assets were sold to meet redemptions and in what manner, for example by vertical slicing: FC;
- the current state of preparedness based on the following information: (i) the set of liquidity management tools available to the funds identified; (ii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iii) the manner in which fund managers themselves would likely respond to a possible resumption in redemptions; (iv) current liquid asset holdings of the funds identified; and (v) the number and nature of investors in the fund, for example retail versus institutional investors: FC.

In its report, ESMA identifies and analyses four main topics:

- Topic “A” (funds’ behaviour at the onset of the pandemic);
- Topic “B” (the current state of preparedness);
- Topic “C” (the resilience to future shocks);
- Topic “D” which is dedicated to the conclusions and on the further actions.

Topics A, B and C will be covered in the following paragraph, while Topic D will be covered separately later on in the text.

In Chapter 5 (pp. 20-41), ESMA gives insights on investment funds with exposures to corporate bonds. In that Chapter, ESMA analyses these funds’ reactions to market stress in February and March 2020 (Section 5.2, pp. 22-32), assesses their current state of preparedness (Section 5.3, pp. 32-38) and estimates their resilience to a potential future shock (Section 5.4, pp. 38-41). Given the tight timeline, the ESMA analysis is quite comprehensive and incorporates a substantial amount of information, which includes the information suggested under (A) and (B). ESMA provides a detailed view on corporate debt funds’ activities during the March turmoil, their current state of preparedness and their resilience to potential future shocks.

Conclusions reached regarding the preparedness of the relevant investment funds and considerations on the additional actions needed: (FC)

In Chapter 7 (pp. 52-62), ESMA presents its conclusions on the assessment of, and on further actions needed to foster, the preparedness of the industry (“Topic D”). These conclusions are derived from the analysis in the foregoing Chapters 5 (corporate debt funds) and 6 (real estate funds). ESMA’s work on this aspect is appropriate and comprehensive.

ESMA states that pockets of vulnerabilities remain, as for some corporate bond funds there is a mismatch between the liquidity of the asset side (fund investments) and the liability side (redemption policies). Moreover, Liquidity Management Tools (LMTs) are not in place for some



funds while in general funds have made only very few adjustments in response to the crisis, pointing to a need for corporate debt funds to prepare better for future episodes of market stress.

ESMA identified five priority areas in order to enhance the preparedness of corporate debt funds for future shocks:

- **Priority area 1** – Ongoing supervision of the alignment of the funds' investment strategies, liquidity profiles and redemption policies. Further analysis is required for corporate debt funds investing in high yield (HY) bonds or loans with daily redemption frequency and no LMTs in place.
- **Priority area 2** – Ongoing supervision of liquidity risk assessment. ESMA identifies gaps in funds' liquidity risk assessments. Essentially, not only redemptions of fund shares but all relevant items on the asset and liability sides of funds' balance sheets should be subject to liquidity stress tests, including margin calls. As ESMA states, most funds using collateral arrangements did not consider shocks to their collateral when running their internal stress testing.
- **Priority area 3** – Fund liquidity profiles. As ESMA states, data collected through reporting under the Alternative Investment Fund Managers Directive (AIFMD) have shown different interpretations of reporting requirements on liquidity profiles by managers that should be addressed in the context of an AIFMD review. Reporting regimes need to be further improved and also aligned to suit both the UCITS and AIFMD frameworks to enhance the common understanding, quality and usability of the reported information. Additional guidance should be given to funds on reporting their liquidity profiles.
- **Priority area 4** – Increase of the availability and use of LMTs. ESMA sees a need to increase the availability and the use of LMTs and reiterates its support for ESRB Recommendation 2017/6. LMTs should be further harmonised throughout the Union.
- **Priority area 5** – Supervision of valuation processes in a context of valuation uncertainty. 15% of corporate funds with exposures to corporate debt were facing substantial valuation uncertainty. Accordingly, NCAs are invited to carry out activities to ensure that funds have valuation procedures and methods in place that can adequately deal with stressed market conditions.



4.1.2 Sub-recommendation A(2). Coordinate a supervisory exercise with NCAs on investment funds that have significant exposures to real estate assets.

ESMA provided the ESRB with an assessment regarding the preparedness of real estate investment funds (REIF) including all the following aspects.

Identification of and engagement with investment funds with large exposures to real estate markets taking into account other characteristics, such as redemption frequency and/or the degree of leverage: (FC)

ESMA describes the criteria used for the identification of the subset of real estate funds in Paragraph 2.3 of the ESMA Report (pp. 11-13). Paragraph 6.1 (p. 43) provides more details for the REIF sample. The coverage of the funds sample was measured by comparing the exposure to real estate assets of the funds in the sample with the exposure of all funds to these asset classes. This methodology makes it possible to take into account the assets acquired through leverage. ESMA and the NCAs agreed on the following selection criteria: open-ended real estate funds with more than €500 million of assets under management, in jurisdictions where there were less than ten funds above this threshold. Alternatively, in jurisdictions where more than ten funds had more than €500 million in Assets under Management (AuM), the reporting threshold was set at €1 billion. Hence, as for corporate bond funds, the methodology chosen by ESMA and the NCAs appropriately addresses the issue of proportionality.

Assessment of the preparedness of the REIF identified for potential future redemption and/or valuation uncertainty shocks: (FC)

This assessment was conducted by considering:

- the current extent of valuation uncertainty and redemption activity based on the following information: (i) valuation uncertainty issues faced by real estate funds in different jurisdictions, if any; (ii) the manner in which LMTs have been used to date, including the specific tools activated; and (iii) the size of redemption requests since the onset of the COVID-19 pandemic and the manner in which the funds identified have responded to these requests: FC
- the current state of preparedness based on the following information: (i) the structural characteristics of real estate funds (e.g. dealing frequency, notice periods, etc.); (ii) the set of LMTs that is available to the funds identified; (iii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iv) the manner in which fund managers themselves would likely respond to an increase in valuation uncertainty/increase in redemptions; (v) the current liquid asset holdings of the funds identified; and (vi) the number and nature of investors in the funds identified (for example, retail versus institutional investors): FC

As before, Topics A, B and C will be covered in the following paragraphs, while Topic D will be covered separately.

Data gathered by NCAs cover inter alia: the breakdown of portfolios between February and March 2020 and in June; redemption levels, availability, use and characteristics of LMTs; issues with



expected cash flows; valuation uncertainties; and loan covenants. To estimate the resilience to future shocks, ESMA analysed potential liquidity mismatches of REIFs by comparing the portfolio liquidity under stressed market conditions and the investor liquidity profiles. The key findings of the assessment considered for REIFs are summarised on page 42 of the ESMA Report. More details are provided throughout Chapter 6 (pp. 42-51) on the composition of the portfolios, the level of redemptions, the availability of LMTs in the various jurisdictions and their use during the period under analysis, funds' performance, the level of leverage, the investor base, and the exposure to potential liquidity mismatches. Finally, the analysis of REIFs' resilience to future shocks is carried out by comparing investor liquidity profiles and asset liquidity profiles under foreseeable and stressed conditions. Funds with daily redemptions are exposed to liquidity issues in the short term due to the intrinsically illiquid nature of the assets.

Conclusions reached regarding the preparedness of the relevant investment funds and considerations on the additional actions needed: (FC)

As described above, ESMA presents its conclusions on the assessment and further actions needed to foster the preparedness of the industry ("Topic D") in Chapter 7 of the ESMA Report. Real estate funds were relatively resilient to the COVID-19 market stress, albeit in a context of low redemptions. The analysis conducted by ESMA shows that there are significant issues around valuation uncertainty, the availability of LMTs, and loan covenants. ESMA sees additional issues specific to REIFs to be addressed in some of the five priority areas identified, in addition to those already identified for each priority area for corporate bond funds (see also the previous section on priority areas identified for corporate bond funds):

- **Priority area 1:** A vulnerability analysis is required for REIFs with high redemption frequency with a short "notice period" and no "gates".
- **Priority area 2:** For REIFs, the risks of loan covenants and related forced sales should be assessed.
- **Priority area 5:** In the context of the supervisory exercise, REIF managers encountered issues with valuations. Accordingly, NCAs are invited to carry out activities to ensure that the valuation procedures used by Alternative Investment Fund Managers (AIFMs) can adequately deal with stressed market situations.

ESMA will follow up with NCAs on priority areas 1, 2, and 5, in order to foster supervisory convergence amongst NCAs on how they supervise firms' compliance with their obligations in the areas of corporate debt funds and REIF. ESMA recommends that priority areas 3 and 4 are taken forward in the context of the AIFMD review.



5 Conclusions

The assessment on Recommendation ESRB/2020/4 on the liquidity risk of investment funds concludes that full compliance has been achieved by ESMA. As recommended by the ESRB, ESMA has coordinated with NCAs to produce a detailed study on the preparedness for potential future shocks of open-ended investment funds with significant exposures to corporate debt or real estate assets and has considered whether there was a need for additional actions. In its analyses, ESMA has adequately addressed the issue of proportionality and conclusions have been reported to the ESRB in due time.

The assessment of the evaluation of the preparedness of investment funds with significant exposures to corporate debt concludes that there is full compliance. ESMA, in consultation with NCAs, considered in its evaluation all open-ended funds with an exposure to corporate debt exceeding €1 billion. The corporate bond funds analysed managed to maintain their activity adequately during the stress period. However, potential liquidity mismatches, an absence of LMTs, and methodological weaknesses in stress testing have been identified as factors fostering vulnerability to future shocks.

The compliance assessment of the evaluation of the preparedness of investment funds with significant exposures to real estate assets also shows full compliance. ESMA, in consultation with NCAs, considered in its evaluation all open-ended real estate funds with more than either €500 million or €1 billion of AuM (depending on the number of funds above the €500 million threshold in each jurisdiction). Analysed real estate funds appeared to be generally resilient during the COVID-19-related market stress. However, high valuation uncertainty in the real estate market might trigger some problems in the aftermath of the stress. Besides, the lack of availability of LMTs and risks related to loan covenants have been identified as factors increasing the vulnerability of these funds to future shocks.

ESMA identified five priority areas to enhance the preparedness of investment funds with significant exposures to corporate debt or real estate assets. ESMA fully complies with the Recommendation in terms of considering whether additional action is needed. These areas are: i) ongoing supervision of the alignment of the funds' investment strategies, liquidity profiles and redemption policies, ii) ongoing supervision of liquidity risk assessment, iii) additional specifications on how liquidity profiles should be established and reported, iv) an increase in the availability and use of LMTs and, v) supervision of valuation processes in a context of valuation uncertainty.



Annex I: Composition of the Assessment Team

(approved by the ATC via Written Procedure ATC/WP/2021/005)

Chairperson	Institutions
Jaga Gänßler	Bundesanstalt für Finanzdienstleistungsaufsicht
Assessment Team	
Mario Cappabianca	Banca d'Italia
Thomas Garcia	Banque de France
Konstantinos Kannelopoulos	Bank of Greece
Jens Lorenz	Bundesanstalt für Finanzdienstleistungsaufsicht
Charles O'Donnell	European Central Bank
Marloes Van Rijsbergen	European Commission
Cristina Vespro	European Commission
Hannes Wilke	Deutsche Bundesbank
Secretariat	
Camille Graciani	Macroprudential Development
Federico Pistelli	Legal Team
Ridha Sahli	Legal Team



Annex II: Implementation Standards for Recommendation ESRB/2020/4

Sub-recommendation A1. (Coordinate a supervisory exercise with the NCAs on investment funds that have significant exposures to corporate debt. Assess and report on their preparedness for potential future adverse shocks)

FC: ESMA provided the ESRB with an assessment regarding the preparedness of corporate bond funds including all of the aspects set out below:

- identification of and engagement with investment funds with large exposures to corporate debt markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the identified corporate bond funds for potential future redemption and/or valuation uncertainty shocks, by considering:
 - the fund behaviour at the onset of the COVID-19 pandemic based on the following information; (i) the level of redemptions seen at the onset of the COVID-19 pandemic, when redemptions from a range of corporate bond funds were elevated; (ii) how LMTs were used at the time, including the specific tools activated by different fund types; and (iii) what types of assets were sold to meet redemptions and in what manner, for example by vertical slicing;
 - the current state of preparedness based on the following information: (i) the set of LMTs available to the funds identified; (ii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iii) the manner in which fund managers themselves would likely respond to a possible resumption in redemptions; (iv) current liquid asset holdings of the funds identified; and (v) the number and nature of investors in the fund, for example retail versus institutional investors.

Conclusions reached regarding the preparedness of the relevant investment funds.

LC: ESMA provided the ESRB with an assessment regarding the preparedness of corporate bond funds including almost all of the following aspects:

- identification of and engagement with investment funds with large exposures to corporate debt markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the identified corporate bond funds for potential future redemption and/or valuation uncertainty shocks, by considering:



- the fund behaviour at the onset of the COVID-19 pandemic based on the following information; (i) the level of redemptions seen at the onset of the COVID-19 pandemic, when redemptions from a range of corporate bond funds were elevated; (ii) how LMTs were used at the time, including the specific tools activated by different fund types; and (iii) what types of assets were sold to meet redemptions and in what manner, for example by vertical slicing;
- the current state of preparedness based on the following information: (i) the set of LMTs available to the funds identified; (ii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iii) the manner in which fund managers themselves would likely respond to a possible resumption in redemptions; (iv) current liquid asset holdings of the funds identified; and (v) the number and nature of investors in the fund, for example retail versus institutional investors.

Conclusions reached regarding the preparedness of the relevant investment funds.

SE N/A

PC ESMA provided the ESRB with an assessment regarding the preparedness of corporate bond funds including most of the following aspects:

- identification of and engagement with investment funds with large exposures to corporate debt markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the corporate bond funds identified for potential future redemption and/or valuation uncertainty shocks, by considering:
 - the fund behaviour at the onset of the COVID-19 pandemic based on the following information; (i) the level of redemptions seen at the onset of the COVID-19 pandemic, when redemptions from a range of corporate bond funds were elevated; (ii) how LMTs were used at the time, including the specific tools activated by different fund types; and (iii) what types of assets were sold to meet redemptions and in what manner, for example by vertical slicing;
 - the current state of preparedness based on the following information: (i) the set of LMTs available to the funds identified; (ii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iii) the manner in which fund managers themselves would likely respond to a possible resumption in redemptions; (iv) current liquid asset holdings of the funds identified; and (v) the number and nature of investors in the fund, for example retail versus institutional investors.

Conclusions reached regarding the preparedness of the relevant investment funds.



MN ESMA provided the ESRB with an assessment regarding the preparedness of corporate bond funds including some of the following aspects:

- identification of and engagement with investment funds with large exposures to corporate debt markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the corporate bond funds identified for potential future redemption and/or valuation uncertainty shocks, by considering:
 - the fund behaviour at the onset of the COVID-19 pandemic based on the following information; (i) the level of redemptions seen at the onset of the COVID-19 pandemic, when redemptions from a range of corporate bond funds were elevated; (ii) how LMTs were used at the time, including the specific tools activated by different fund types; and (iii) what types of assets were sold to meet redemptions and in what manner, for example by vertical slicing;
 - the current state of preparedness based on the following information: (i) the set of LMTs available to the funds identified; (ii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iii) the manner in which fund managers themselves would likely respond to a possible resumption in redemptions; (iv) current liquid asset holdings of the funds identified; and (v) the number and nature of investors in the fund, for example retail versus institutional investors.

Conclusions reached regarding the preparedness of the relevant investment funds.

NC ESMA provided the ESRB with an assessment regarding the preparedness of corporate bond funds which included hardly any or none of the following aspects:

- identification of and engagement with investment funds with large exposures to corporate debt markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the identified corporate bond funds for potential future redemption and/or valuation uncertainty shocks, by considering:
 - the fund behaviour at the onset of the COVID-19 pandemic based on the following information; (i) the level of redemptions seen at the onset of the COVID-19 pandemic, when redemptions from a range of corporate bond funds were elevated; (ii) how LMTs were used at the time, including the specific tools activated by different fund types; and (iii) what types of assets were sold to meet redemptions and in what manner, for example by vertical slicing;
 - the current state of preparedness based on the following information: (i) the set of LMTs available to the funds identified; (ii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iii) the manner in which fund managers themselves would likely respond to a possible resumption in redemptions; (iv) current liquid asset holdings of the funds identified; and (v) the number and nature of investors in the fund, for example retail versus institutional investors.

Conclusions reached regarding the preparedness of the relevant investment funds.

IE: N/A



Sub-recommendation A2. (Coordinate a supervisory exercise with the NCAs on investment funds that have significant exposures to real estate assets. Assess and report on their preparedness for potential future adverse shocks.)

FC: ESMA provided the ESRB with an assessment regarding the preparedness of real estate funds including all of the following aspects:

- identification of and engagement with investment funds with large exposures to real estate markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the identified real estate funds for potential future redemption and/or valuation uncertainty shocks, by considering
 - the current extent of valuation uncertainty and redemption activity based on the following information: (i) valuation uncertainty issues faced by real estate funds in different jurisdictions, if any; (ii) the manner in which LMTs have been used to date, including the specific tools activated; and (iii) the size of redemption requests since the onset of the COVID-19 pandemic and the manner in which the funds identified have responded to these requests);
 - the current state of preparedness based on the following information: (i) the structural characteristics of real estate funds (e.g. dealing frequency, notice periods, etc.); (ii) the set of LMTs that is available to the funds identified; (iii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iv) the manner in which fund managers themselves would likely respond to an increase in valuation uncertainty/increase in redemptions; (v) the current liquid asset holdings of the funds identified; and (vi) the number and nature of investors in the funds identified (for example, retail versus institutional investors).

Conclusions reached regarding the preparedness of the relevant investment funds.

LC: ESMA provided the ESRB with an assessment regarding the preparedness of real estate funds including almost all of the following aspects:

- identification of and engagement with investment funds with large exposures to real estate markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the identified real estate funds for potential future redemption and/or valuation uncertainty shocks, by considering:
 - the current extent of valuation uncertainty and redemption activity based on the following information: (i) valuation uncertainty issues faced by real estate funds in different jurisdictions, if any; (ii) the manner in which LMTs have been used to date, including the specific tools activated; and (iii) the size of redemption requests since the onset of the



COVID-19 pandemic and the manner in which the funds identified have responded to these requests);

- the current state of preparedness based on the following information: (i) the structural characteristics of real estate funds (e.g. dealing frequency, notice periods, etc.); (ii) the set of LMTs that is available to the funds identified; (iii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iv) the manner in which fund managers themselves would likely respond to an increase in valuation uncertainty/increase in redemptions; (v) the current liquid asset holdings of the funds identified; and (vi) the number and nature of investors in the funds identified (for example, retail versus institutional investors).

Conclusions reached regarding the preparedness of the relevant investment funds.

SE N/A

PC ESMA provided the ESRB with an assessment regarding the preparedness of real estate funds including most of the following aspects:

- identification of and engagement with investment funds with large exposures to real estate markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the identified real estate funds for potential future redemption and/or valuation uncertainty shocks, by considering:
 - the current extent of valuation uncertainty and redemption activity based on the following information: (i) valuation uncertainty issues faced by real estate funds in different jurisdictions, if any; (ii) the manner in which LMTs have been used to date, including the specific tools activated; and (iii) the size of redemption requests since the onset of the COVID-19 pandemic and the manner in which the funds identified have responded to these requests);
 - the current state of preparedness based on the following information: (i) the structural characteristics of real estate funds (e.g. dealing frequency, notice periods, etc.); (ii) the set of LMTs that is available to the funds identified; (iii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iv) the manner in which fund managers themselves would likely respond to an increase in valuation uncertainty/increase in redemptions; (v) the current liquid asset holdings of the funds identified; and (vi) the number and nature of investors in the funds identified (for example, retail versus institutional investors).

Conclusions reached regarding the preparedness of the relevant investment funds.



MN ESMA provided the ESRB with an assessment regarding the preparedness of real estate funds including some of the following aspects:

- identification of and engagement with investment funds with large exposures to real estate markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the real estate funds identified for potential future redemption and/or valuation uncertainty shocks, by considering:
 - the current extent of valuation uncertainty and redemption activity based on the following information: (i) valuation uncertainty issues faced by real estate funds in different jurisdictions, if any; (ii) the manner in which LMTs have been used to date, including the specific tools activated; and (iii) the size of redemption requests since the onset of the COVID-19 pandemic and the manner in which the funds identified have responded to these requests);
 - the current state of preparedness based on the following information: (i) the structural characteristics of real estate funds (e.g. dealing frequency, notice periods, etc.); (ii) the set of LMTs that is available to the funds identified; (iii) the manner in which fund managers themselves are preparing for any possible future adverse shocks; (iv) the manner in which fund managers themselves would likely respond to an increase in valuation uncertainty/increase in redemptions; (v) the current liquid asset holdings of the funds identified; and (vi) the number and nature of investors in the funds identified (for example, retail versus institutional investors).

Conclusions reached regarding the preparedness of the relevant investment funds.

NC: ESMA provided the ESRB with an assessment regarding the preparedness of real estate funds including hardly any or none of the following aspects:

- identification of and engagement with investment funds with large exposures to real estate markets that are particularly important from a macroprudential perspective also taking into account other characteristics, such as redemption frequency and/or the degree of leverage;
- assessment of the preparedness of the real estate funds identified for potential future redemption and/or valuation uncertainty shocks, by considering:
 - the current extent of valuation uncertainty and redemption activity based on the following information: (i) valuation uncertainty issues faced by real estate funds in different jurisdictions, if any; (ii) the manner in which LMTs have been used to date, including the specific tools activated; and (iii) the size of redemption requests since the onset of the COVID-19 pandemic and the manner in which the funds identified have responded to these requests);
 - the current state of preparedness based on the following information: (i) the structural characteristics of real estate funds (e.g. dealing frequency, notice periods, etc.); (ii) the set of LMTs that is available to the funds identified; (iii) the manner in which fund



managers themselves are preparing for any possible future adverse shocks; (iv) the manner in which fund managers themselves would likely respond to an increase in valuation uncertainty/increase in redemptions; (v) the current liquid asset holdings of the funds identified; and (vi) the number and nature of investors in the funds identified (for example, retail versus institutional investors).

Conclusions reached regarding the preparedness of the relevant investment funds.

IE: N/A



Abbreviations

I. Compliance grades

FC	Fully compliant
LC	Largely compliant
PC	Partially compliant
MN	Materially non-compliant
NC	Non-compliant
IE	Inaction insufficiently explained
SE	Inaction sufficiently explained

II. Countries/Addressees

AT	Austria	LV	Latvia
BE	Belgium	LT	Lithuania
BG	Bulgaria	LU	Luxembourg
CZ	Czech Republic	HU	Hungary
DK	Denmark	MT	Malta
DE	Germany	NL	Netherlands
EE	Estonia	PL	Poland
IE	Ireland	PT	Portugal
GR	Greece	RO	Romania
ES	Spain	SI	Slovenia
FR	France	SK	Slovakia
HR	Croatia	FI	Finland
IT	Italy	SE	Sweden
CY	Cyprus	UK	United Kingdom



III. Other abbreviations

AIFMD	Alternative Investment Fund Managers Directive
ECB	European Central Bank
EEA	European Economic Area
ESRB	European Systemic Risk Board
ESRB Handbook	Handbook on the assessment of compliance with ESRB Recommendations (April 2016)
ESRB Regulation	Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board
ESRB Rules of Procedure	Decision of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board (ESRB/2011/1)
EU/Union	European Union
IMSC	Investment Management Standing Committee
Handbook	ESRB Handbook on the assessment of compliance with ESRB Recommendations, April 2016
HY	high yield
LMT	Liquidity Management Tool
NCAs	National Competent Authority
REIF	Real Estate Investment Fund



Imprint and acknowledgements

This Compliance report is based on the results of the assessment conducted by the Assessment Team and was prepared by:

Jaga Gänßler (Chairperson)

Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)

Mario Cappabianca

Banca d'Italia

Thomas Garcia

Banque de France

Konstantinos Kanellopoulos

Bank of Greece

Jens Lorenz

Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)

Charles O'Donnell

European Central Bank

Marloes Van Rijsbergen

European Commission

Cristina Vespro

European Commission

Hannes Wilke

Deutsche Bundesbank

Camille Graciani

ESRB Secretariat

Aleksandra Granat

ESRB Secretariat

Federico Pistelli

ESRB Secretariat

Ridha Sahli

ESRB Secretariat

© European Systemic Risk Board, 2020

Postal address 60640 Frankfurt am Main, Germany
Telephone +49 69 1344 0
Website www.esrb.europa.eu

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The cut-off date for the data included in this report was 30 June 2021.

For specific terminology please refer to the [ESRB glossary](#) (available in English only).

PDF ISBN 978-92-9472-244-7, doi:10.2849/647108, DT-08-21-286-EN-N