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Re: 2022 ESMA Common Supervisory Action on Asset Valuation

Dear Chair,

In 2022, the Central Bank of Ireland (the 'Central Bank') undertook a review of Asset Valuation as part of the European Securities and Markets Authority's ('ESMA') Common Supervisory Action ('CSA').

The purpose of this letter is to highlight the main findings of this work, set out the Central Banks expectations and to identify the key actions to be taken by all Firms to mitigate the issues identified. Firms should consider the contents of this letter in conjunction with ESMA's report[1], which was published on 24 May 2023.

As part of the CSA, the Central Bank was required to investigate whether Irish Fund Management Companies ('Firms'):

- Comply with the respective UCITS and AIFM Directives/Regulations with respect to asset valuation;
- Adhere to valuation principles[2] and methodologies with a view to reflecting a true and fair view of their financial positions both under normal and stressed market conditions in line with applicable rules;
- Evaluate how Firms policies and procedures worked during the COVID-19[3] pandemic.

[1] ESMA Final Report on Asset Valuation 2023
[2] Including the IOSCO's Principles for the Valuation of Collective Investment Schemes Principles for the Valuation of Collective Investment Schemes (iosco.org).
[3] For the purposes of the CSA, the timeframe for the COVID element is March 2020 – June 2020.

The CSA was primarily a qualitative assessment, which comprised of a questionnaire issued to Firms, a desk based review of submissions, virtual inspection calls and on-site inspections. In order to satisfy the prescribed ESMA sample threshold, the Central Bank required a sample of 30 Firms (the 'Sample') to complete the questionnaires. Each submission was subject to an in-depth desk-based supervisory review, with 40% of Firms subject to further engagement through inspection calls and on-site inspections.

The Central Bank would like to thank Firms for their engagement and collaboration during this CSA, where the overall level of compliance with the relevant legislation was found to be good. The majority of the Firms in the sample were able to demonstrate adherence to the relevant legislation and supervisory expectations as outlined in the scope and assessment framework of the CSA.

However, supervisors did identify a significant minority of Firms who could **not** evidence compliance with the expectations of the Central Bank and the legislative requirements in relation to their asset management frameworks. Risk Mitigation Programmes ('RMP's') were issued to a number of these Firms.

While good levels of compliance were noted, Firms are reminded that they must continually be evaluating the adequacy of their Asset Valuation control frameworks, and take the necessary steps to strengthen arrangements where weaknesses are identified. The findings and observations outlined below are an important reference for Firms in reviewing their valuation arrangements. Firms should take a proactive approach to the identification and implementation of improvements required to their frameworks in order to mitigate against key risks which the Firms and investors may be exposed to.

Before we move to the detailed findings and observations, the Central Bank would like to draw your attention to issues we observed in relation to the overall quality of responses to this CSA questionnaire.

For the vast majority of Firms, deficiencies in the quality and detail of the information provided, required the Central Bank to conduct follow-up engagement in order to gather further evidence and information. Where Firms provide insufficient detail and information, this impedes supervisors in conducting a comprehensive supervisory assessment of Firms' compliance with the relevant legislation, while working to strict deadlines prescribed by ESMA. Firms should ensure that Senior Management review all information before submitting to the Central Bank. Ongoing issues with the quality of submissions to future CSA's will be addressed directly with Firms and their respective Supervision teams at the Central Bank.

Outlined below are the key findings, observations and actions which should be considered in conjunction with ESMA's final report on the CSA[4].

Findings

1) Use of group asset valuation policies and procedures

Some Firms continue to rely on group valuation policies or procedures with limited or no reference to their Irish operations. Group policies and procedures may not capture the local regulatory environment or the operational roles and responsibilities of those parties involved in the Irish asset valuation process. This could lead to inaccuracies in the valuation process at the Irish entity.

2) Lack of formal asset valuation error procedures

Supervisors identified Firms who did not have stand-alone asset valuation error procedures in place to outline the controls and escalation measures to be applied should a valuation error or incorrect calculation of the NAV occur. This could lead to the unfair treatment of investors where pricing or NAV errors occur.

[4] ESMA Final Report on Asset Valuation 2023

In addition, a number of Firms provided copies of error procedures, which did not sufficiently outline how the Fund would revalue, recalculate and resettle affected transactions and did not provide any or very limited detail on policies and procedures for determining or processing investor compensation.

3) Poor quality of asset valuation policies and procedures

A minority of Firms were identified as having poor quality asset valuation policies and procedures which fell below the level of detail that would be reasonably required to cover the valuation process. Extracts from fund documentation or operations manuals are not a substitute for standalone asset valuation policies and procedures that have been subject to a robust governance process. The asset valuation process at Firms should be supported by documented policies and procedures, which clearly outline the operational tasks and responsibilities for all parties involved in the asset valuation process to ensure a true and fair representation of the financial position of funds.

4) Limited evidence of periodic reviews

The majority of Firms could not demonstrate that periodic reviews were performed on their asset valuation policies and procedures. This cohort of Firms had no documented evidence of reviews taking place, poor or no version control and could not evidence a clear governance process in place to conduct and follow up these reviews. Of the remaining Firms who did provide evidence, this was in the form of either documented board minutes or evidence of version control captured on the documents. This could lead to deficiencies in valuation methodologies or models being utilised, resulting in incorrect valuations of assets being produced.

Observations

1) Liquidity Stress Testing

As part of this review, supervisors assessed the extent to which supervised entities performed liquidity stress testing and scenario analysis.

While all Firms confirmed they carry out stress testing and scenario analysis, Firms are reminded that, when they are conducting regular stress testing and scenario analysis, the results of this testing and analysis should be incorporated into liquidity management frameworks and be used to manage and inform decision making, risk management and risk mitigation. Decisions taken as a result of such work should be formally documented and approved.

2) Independence of the Asset Valuation Function at Firms

The review highlighted that some Firms' asset valuation policies and procedures do not clearly set out the allocation of operational tasks and responsibilities in the asset valuation function, which has the potential to give rise to conflicts of interest. Whilst Firms may take different approaches to ensure independence across the valuation function, Firms should ensure that there is clear segregation of roles and independence within the valuation function.

Action required

- All Firms should have documented, comprehensive and entity specific asset valuation policies and procedures which clearly outline the operational roles and responsibilities for all parties involved in the asset valuation process. Firms should ensure that there is clear ownership for asset valuation policies, procedures and the review process, which are adhered to and embedded in the Firm's asset valuation process.
- Asset valuation policies and procedures should be subject to review by senior management at least annually or where required throughout the year to ensure they remain fit for purpose. Reviews should be performed by persons with appropriate knowledge and experience and the approved valuation methodologies and models should be applied consistently across all funds under management for each Firm.

- All Firms should have a formalised and comprehensive errors procedure in place to ensure remedial action is implemented when valuation errors or incorrect calculations of the NAV occur. These procedures should also be reviewed at least annually and updated where required.
- All Firms are required to consider the observations outlined above to determine if any action is required in relation to arrangements currently in place.

Firms are required to conduct a review of their asset valuation frameworks to ensure they continue to be fit for purpose and adhere to all relevant legislative requirements including the expectations above. This review should be completed by the end of Q2 2024.

In circumstances of non-compliance by any Firm with respect to any requirements relevant to the matters raised in this letter, the Central Bank may, in the course of future supervisory engagement, or when exercising its supervisory and/or enforcement powers in respect of such non-compliance, have regard to the consideration given by a Firm to the matters raised in this letter. The findings from this review will inform future policy development and enhancements to the current regulatory framework for the supervision of asset valuations.

The contents of this letter should be brought to the attention of the Board for consideration and the appropriate action should be taken without delay.

Should you have any queries regarding the content of this letter, please contact commonsupervisoryaction@centralbank.ie

Yours sincerely

D.Rossi

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Head of Funds Supervision Division