ESMA
European Securities and Markets Authority

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Final Report

On the 2022 CSA on valuation

ESMA
European Securities and Markets Authority

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1 Executive Summary

Reasons for publication

In January 2022, ESMA launched a Common Supervisory Action (CSA) with National Competent Authorities (NCAs) on the supervision of the asset valuation rules under the UCITS and AIFM Directives.

The CSA's aim was to assess, foster and enforce the compliance of supervised entities with the organisational requirements with respect to asset valuation, as well as adherence to valuation principles and methodologies with a view to reflecting a true and fair value of their financial positions both under normal and stressed market conditions in line with the applicable rules.

This report sets out ESMA's analysis and conclusions on the CSA exercise and presents ESMA's views on the findings. It concludes with the follow-up actions envisaged by NCAs.

Contents

Section 2 explains the background of the exercise, Section 3 the scope of the analysis and minimum coverage thresholds, and Sections 4 to 8 set out the CSA's main findings, on the following topics:

a) **the appropriateness of valuation policies and procedures**: broadly, NCAs reported a satisfactory level of compliance by supervised entities, however there is room for improvement on a few deficiencies which were detected regarding: (i) lack of documented and established valuation policies and procedures (including regular reviews) that clearly allocate operational tasks and responsibilities for asset valuation; and (ii) lack of a clear definition of the valuation model to be applied, as well as its validation;

b) **valuation under stressed market conditions**: most NCAs reported that the majority of managers in scope of the exercise periodically perform stress tests to monitor the liquidity level of their portfolio, however issues were spotted on valuation policies and procedures that do not distinguish between normal and stressed market conditions and lack of systematic incorporation of the outcome of Liquidity Stress Testing, particularly for less-liquid assets;

c) **independence of the valuation function and use of third-party valuers**: despite an overall positive assessment from NCAs, issues arose in some specific cases with regards to: (i) the lack of independence of the valuation function, particularly from the portfolio management and (ii) smaller managers which, in some instances, appeared to over-rely on third-party data providers for the pricing of less liquid assets, without performing the appropriate checks, controls and back testing;

d) **early detection mechanisms for valuation errors and transparency to investors**: while, on substance, the results of the analysis showed a broad level of

compliance, the analysis suggests that remedial procedures to ensure an early detection of valuation errors and full investors' compensation are not always appropriately formalised;

e) **focus on Private Equity (PE) and Real Estate (RE) assets**: issues arise in the alignment between the NAV calculation, the asset valuation frequency and the availability of up-to-date data not only for PE funds, but for all funds invested in less liquid assets and, even more so, for those funds offering daily redemptions, such as some types of Real Estate funds.

The follow-up actions envisaged by NCAs are described under Section 9.

Next steps

The deterioration of the macroeconomic outlook, combined with the tightening of financial conditions, heightened inflation and increased interest rates level, compounds challenges for ensuring a fair valuation of assets at all times and especially under stressed market conditions.

In light of the current economic environment, it is important that NCAs' supervision addresses the deficiencies identified in the course of the CSA exercise and keeps paying close attention to potential valuation issues arising from less liquid assets, whose nature can amplify the structural liquidity mismatches of certain types of investment funds. This is particularly true for funds investing in Private Equity (PE) assets and Real Estate (RE) which might be more exposed to revaluation risks in light of the heavy reliance on long-term models and the illiquidity of their assets.[1]

Building on the findings of the CSA exercise, ESMA will facilitate discussions among NCAs on the topic of asset valuation, particularly under stressed market conditions, in order to ensure that both market participants and NCAs are better prepared to address valuation-related challenges in future periods of stress. Moreover, ESMA welcomes that NCAs have planned to follow-up on the deficiencies identified in the course of the CSA and encourages the use of enforcement, where appropriate.

[1] As also indicated by the December 2022 ESRB Recommendation, it is important to improve the monitoring of the vulnerabilities stemming from the real estate sector that could be a source of risk to financial stability, particularly under the current economic conditions characterised by a heightened inflation and the deterioration in the growth outlook. See Recommendation of the European Systemic Risk Board of 1 December 2022 on vulnerabilities in the commercial real estate sector in the European Economic Area (ESRB/2022/9) (europa.eu)

2 Background

1. In January 2022, ESMA launched a CSA with NCAs on the valuation of UCITS and open-ended AIFs[2] with a view of further enhancing supervisory convergence in this area. The CSA aimed at investigating whether authorised managers[3] of UCITS and open-ended AIFs:

    a) comply with the organisational requirements set out in the UCITS and AIFMD frameworks with respect to asset valuation;

    b) adhere to valuation principles[4] 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.

2. While the AIFMD and UCITS frameworks include provisions on the implementation of the valuation function and the required policies and procedures, as well as on the disclosure to investors, the rules applicable to the valuation of assets are not harmonised at the level of the EU and are therefore subject to national legislation[5].

3. In this context, the CSA provided for a valuable opportunity to exchange knowledge and experiences amongst NCAs on their supervisory approaches to addressing adherence with fair value principles, both under normal and stressed market conditions, and ensuring that UCITS and open-ended AIFs have implemented sufficiently sound valuation policies and procedures, as well as provide appropriate disclosures on valuation-related matters to investors. The CSA also aimed to ensure that both market participants and NCAs are better prepared to address valuation-related challenges in future periods of stress.

4. Since the emergence of the Covid-19 pandemic, NCAs have identified several challenges related to the asset valuation, including:

a) the consistent application of valuation rules;

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[2] ESMA launches a Common Supervisory Action on valuation of UCITS and open-ended AIFs.
[3] For the purpose of this document, the term "manager" refers to: (a) in relation to a UCITS, the UCITS management company or, in the case of a self-managed UCITS, the UCITS investment company; (b) in relation to an AIF, the AIFM or an internally-managed AIF.
[4] Including the IOSCO Principles for the Valuation of Collective Investment Schemes, available at Principles for the Valuation of Collective Investment Schemes (iosco.org).
[5] While the general valuation requirements in the AIFMD and UCITS Level 1 frameworks are similar, the newer AIFMD requirements are often more granular and supported by additional Level 2 rules. Against this background, ESMA has considered it essential for the purpose of enhancing supervisory convergence to have a harmonised approach to addressing the valuation risks faced by AIFs and UCITS. To this end, ESMA has recommended that NCAs should aim at ensuring that UCITS investors, which are often retail investors, benefit from at least the same level of protection as AIF ones, which are often professional investors.

b) the existence of different valuation standards for the same category of assets/type of funds;

c) insufficient control procedures implemented by the management companies on the quality of external valuers and/or overreliance on external reports/valuers;

d) weakness of internal models considered due to high subjectivity on adopted assumptions;

e) issues with valuation under stressed market conditions;

f) supervisory convergence risks across the EU/EE.

5. Against this background, it was agreed to focus the CSA on authorised managers of UCITS and open-ended AIFs investing in less-liquid assets (unlisted equities, unrated bonds, corporate debt, real estate, high yield bonds, emerging markets, listed equities that are not actively traded, bank loans), as this is the category of assets more impacted by valuation issues especially during stressed market conditions.[6]

6. The work was conducted on the basis of a common methodology developed by ESMA between July and November 2021 and was agreed with NCAs in December 2021. The CSA assessment framework, including scope, coverage thresholds, methodology, supervisory expectations and timeline, is a joint effort to carry out a comprehensive supervisory action in a convergent manner.

7. In the course of 2022, NCAs shared their knowledge and experience to promote supervisory convergence on how they supervise valuation-related issues, with the objective to achieve an effective supervision of valuation methodologies, policies and procedures ensuring that less-liquid assets are valued fairly both during normal and stressed market conditions, as well as appropriate investor disclosures, in line with applicable rules. NCAs were asked to report to ESMA on the CSA results in their jurisdictions by 31 December 2022.

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[6] Funds exposed to less-liquid assets had already been identified as particularly high priority for enhanced scrutiny from a financial stability perspective by the European Systemic Risk Board (ESRB). In this context, in May 2020, the ESRB recommended that ESMA coordinates a focused supervisory engagement of NCAs with investment funds that have significant exposures to Corporate Debt (CD) and Real Estate (RE), in order to assess their preparedness to potential future redemptions and valuation shocks. In response to the ESRB Recommendation, ESMA coordinated a supervisory exercise which included some NCAs collecting data on funds exposed to such assets. The 2022 CSA on valuation gave the opportunity to those NCAs which did not have any CD and/or RE fund(s) in the scope of the ESRB exercise to also focus on those types of funds, while leaving the choice to the other NCAs already involved in the ESRB exercise whether or not to further look into those types of funds, or to include in the scope of the CSA exercise CD and RE funds different from the one(s) in the sample of the ESRB exercise. See Recommendation of the European Systemic Risk Board on liquidity risks in investment funds (ESRB/2020/4) (europa.eu), as well as the ESMA Final Report available at esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf (europa.eu), in particular, "Priority Area 5" which focused on the soundness of valuation processes in a context of valuation uncertainty. Further information on the outcome of the follow-up work related to the priority areas defined in the ESMA Final Report are available under Section IV of this Report.

8. Following the Russian invasion of Ukraine, ESMA invited NCAs to use the opportunity of this CSA to also investigate issues with respect to the fair valuation of Russian/Ukrainian and Belarusian assets. Subsequently, several NCAs decided to add to the scope of the CSA managers of funds affected by the liquidity and valuation issues stemming from the Russian invasion of Ukraine. Furthermore, as part of its actions to manage the impact of the Russian invasion of Ukraine on investment fund portfolios, in May 2022, ESMA published a public statement to promote convergence in relation to the valuation of Russian, Belarusian and Ukrainian assets, including where the use of liquidity management tools (LMTs), specifically side pockets, may be warranted.[7]

9. Finally, following the completion of the CSA exercise, ESMA launched a survey (the "CSA survey") addressed to NCAs in order to assess the impact of the exercise and to take stock on any type of follow-up actions envisaged/taken by NCAs.[8]

[7] Public statement: Actions to manage the impact of the Russian invasion of Ukraine on investment funds portfolio.
[8] The following NCAs did not yet participate to the survey: CySEC, Cyprus and Central Bank of Hungary.

3 Scope of the analysis and minimum coverage threshold

10. To ensure supervisory convergence in relation to the sample size and the overall coverage of the CSA across Member States, minimum coverage thresholds in terms of number of UCITS and open-ended AIF managers, as well as Assets under Management (AuM) of managers of UCITS and open-ended AIFs established in each jurisdiction were agreed.

11. All NCAs have met the criteria for the minimum coverage of managers of UCITS and open-ended AIFs across all the EU/EEA Member States, with some NCAs even increasing the expected coverage and including closed-ended AIFs marketed to retail investors.

12. NCAs followed the approach set out in the CSA assessment framework in relation to the selection of the sample. Accordingly, they focused on the following categories of fund managers investing in "less-liquid" assets[9]:

    a) unlisted equities;

    b) unrated bonds;

    c) Corporate Debt (CD);

    d) Real Estate (RE);

    e) High Yield (HY) bonds;

    f) Emerging Markets (EM) equities or bonds;

    g) listed equities not actively traded;

    h) bank loans.

13. Furthermore, NCAs were given discretion on the selection of the sample and on the identification of the asset classes that needed more urgent scrutiny in their jurisdictions to be able to focus on managers with potentially high valuation risks, taking into account the size in terms of AuM (with a preference for covering both entities with large AuM, as well as smaller/mid-sized players to have a representative sample), type and

[9] The ESRB considers RE funds and bond funds investing in non-investment grade or unrated securities as examples of less-liquid funds. See ESRB/2017/6, available at Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6) (europa.eu), p. 23 and 25. Furthermore, the FSB lists property, HY corporate bonds and bonds issued in emerging market as examples of less-liquid assets. See Holistic Review of the March Market Turmoil, 17 November 2020, available at Holistic review of the March market turmoil (fsb.org), p. 41.

number of investors (both retail and professional) as well as investors' geographical location, potentially including cross-border cases.

14. For the purpose of performing the CSA, the majority of NCAs took advantage of the tools developed at national level during the Covid-19 pandemic (e.g.: online reporting systems and secured exchange platforms for the data sharing). Most NCAs chose a desk-based approach and only conducted on-site inspections where necessary. Few NCAs opted for a combined approach of both desk-based review and onsite inspections.

15. While NCAs were provided with discretion to calibrate and complement the CSA assessment framework taking into account the applicable requirements at national level and/or the characteristics of their markets, the majority of NCAs did not raise any additional questions and only followed up with managers in specific circumstances (e.g.: in case of unclear or ambiguous responses). A few NCAs included in the scope of the CSA funds investing in assets impacted by the Russian invasion of Ukraine and added questions to managers in relation to the valuation challenges encountered during this period.

16. Finally, the majority of NCAs did not report any information exchange with other NCAs as they had no cross-border cases in their samples. For those NCAs who did exchange information on a cross-border basis, the level of cooperation between home and host NCAs was considered very efficient, with a rapid and complete exchange of information.

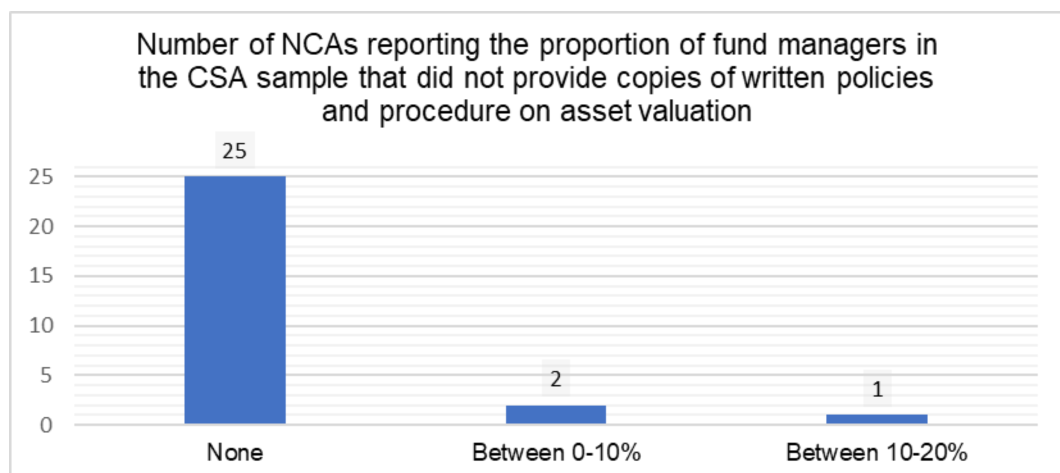
17. ESMA welcomes the efforts made by NCAs in meeting the minimum coverage thresholds and in selecting a diversified sample of entities in the scope of the CSA exercise, taking into account the criteria identified in the CSA assessment framework.

4 Appropriateness of valuation policies and procedures

18. The CSA assessment framework covered a number of provisions related to the implementation and periodic review of documented valuation policies and procedures. Those provisions require, *inter alia*, that managers should have in place policies and procedures ensuring a sound, transparent, comprehensive, and appropriately documented valuation process. More specifically, policies and procedures – including valuation methodologies – should be reviewed at least annually and in any event before the fund engages in a new investment strategy or a new type of asset that is not covered by the valuation policy. The valuation procedures and the chosen methodologies are to be applied consistently across all the funds managed by the same manager, taking into account the type of assets and the investment strategy of the fund.

19. Broadly, NCAs reported a satisfactory level of compliance by supervised entities with regard to the applicable EU rules, with the majority of managers in scope of the exercise complying with the relevant regulatory provisions on asset valuation and providing copies to the NCAs of the relevant valuation policies and procedures. This result is also confirmed by the outcome of the CSA survey (see Table 1) which showed that the large majority of NCAs have received copies of the relevant written policies and procedures on asset valuation; only two NCAs reported that 10% of the managers in their CSA sample did not provide the relevant documentation, and one NCA reported a percentage between 10% and 20%.

Table 1



20. Most NCAs confirmed that similar assets are valued consistently across all funds managed by the same manager, unless national rules or best practices prescribe a different approach and highlighted that derogations to the standard valuation procedure are subject to specific validation and documented processes.

21. However, some issues were detected by various NCAs with respect to the quality of the valuation policies and procedures, namely:

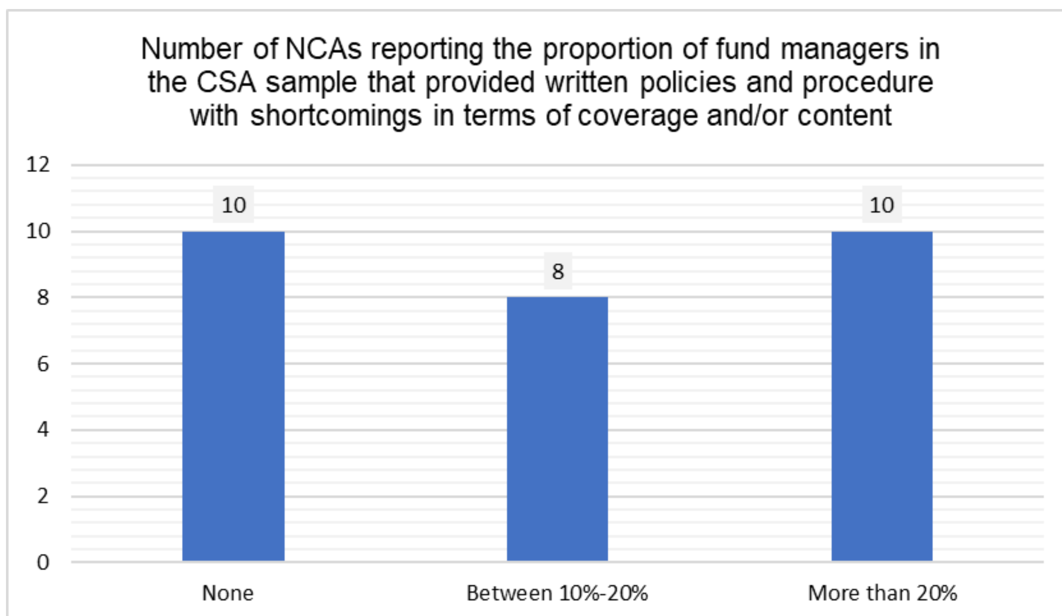
   a) lack of documented and well-established valuation policies and procedures (including regular reviews);

   b) lack of clear allocation of operational tasks/organisational structure, including an unclear identification of the person in charge of the validation of valuation models;

   c) valuation policies and procedures not clearly defining the valuation methodology to be applied and lack of evidence of the process applied to validate the models.

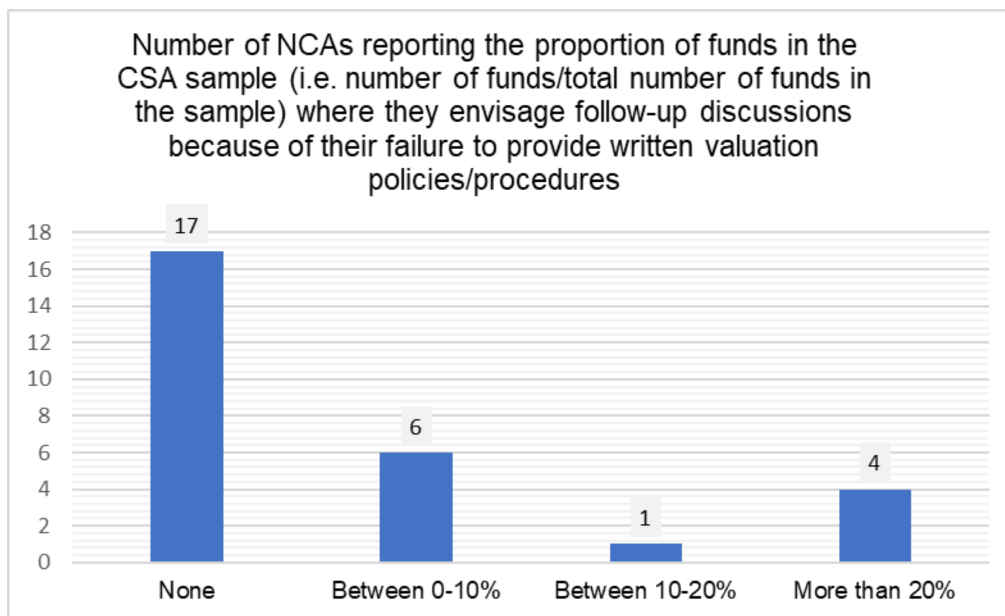
22. The above outcome was also confirmed by the results of the CSA survey (see Table 2), whereby the majority of NCAs reported shortcomings in valuation policies and procedures in terms of coverage and/or content.

Table 2



23. Furthermore, as shown in Table 3, the majority of NCAs indicated that they do not plan to engage in follow-up discussions with the managers in the scope of this exercise, in light of the fact that they were able to provide written copies of the relevant valuation policies or procedures. However, the three NCAs that reported cases where the managers failed to provide the relevant written policies and procedures, confirmed that they envisage to engage in follow-up discussions, and other eight NCAs that did receive the written copies planned to engage in follow-up discussions in light of the weaknesses identified in the valuation policies.

Table 3



ESMA views

I. ESMA would like to highlight the importance of all fund managers having in place valuation policies and procedures that are well-established and documented and clearly allocate operational tasks and responsibilities for asset valuation. In this context, ESMA would like to stress that valuation policies and procedures should always be subject to regular controls and provide for reporting to senior management to ensure timely remediation of shortcomings.

II. ESMA considers that a proper, well-documented and regular review of the valuation models is important, particularly for less-liquid assets, in light of the material risk of inappropriate valuation. Validation of valuation methods should be performed by persons that have appropriate knowledge and experience and

who have not been involved in the process of building that model.[10] Moreover, there should be a regular assessment of pricing/market data sources, as well as the soundness of the data input to the models.

III. ESMA encourages all NCAs to follow-up on the outcome of the CSA exercise to ensure that all supervised entities where deficiencies have been identified have in place documented and well-established valuation policies and procedures of sufficient quality, in line with the relevant regulatory requirements and best practices.

5 Valuation under stressed market conditions

24. The CSA also covered managers' compliance to the rules aimed at ensuring that UCITS and AIFs have sufficiently sound valuation policies and procedures in place, both under normal and stressed market conditions, and provide appropriate investor disclosure.

25. Funds investing in less-liquid assets have inherently less flexibility to improve their overall liquidity by selling assets at a limited discount and recent crisis events have shown the importance for fund managers to incorporate in their policies and procedures the results of LSTs, in order to take into account the potential difficulties of reliably pricing less-liquid assets during a period of market stress. The nature of less-liquid assets can place even more emphasis on the importance of managers ensuring that investors are treated fairly and equally during stressed market conditions and LST could therefore help managers to establish a governance framework seeking to support fair outcomes for all investors, by modelling a fair method for liquidating assets.[11]

26. Most NCAs have reported that the majority of the managers in the scope of the CSA exercise take into account liquidity risks in the valuation of their assets and periodically perform stress tests to monitor the liquidity level of their portfolio. However, several NCAs spotted some deficiencies regarding valuation policies and procedures that do not distinguish between normal and stressed market conditions, or which do not incorporate the results of the LST in line with the ESMA LST Guidelines.[12] This finding is in line with the outcome of the follow-up work undertaken by ESMA and the NCAs with regard to the priority areas identified in the ESMA Report following the May 2020

[10] See also Art. 68 of AIFMD Level 2 Regulation.
[11] See esma34-39-897_guidelines_on_liquidity_stress_testing_in_ucits_and_aifs_en.pdf (europa.eu), in particular, Section V.1.14.
[12] Ibidem.

ESRB Recommendation, which highlighted some room for improvement and continued monitoring on LST and valuation of less-liquid assets.[13]

27. Furthermore, NCAs reported divergent findings regarding the impact of the Covid-19 crisis on funds' portfolios. While some of the managers stated that the impact of the crisis was limited, other managers that experienced such impact on their portfolios confirmed to have introduced a specific Covid-19 scenario in their models (e.g.: historical stress test scenarios based on cash outflows experienced during the Covid-19 crisis).

ESMA views

IV. ESMA would like to remind the importance of ensuring that valuation policies and procedures clearly define the valuation method/methodology to be applied, especially under stressed market conditions, clearly establish the monitoring systems in place (e.g.: bid-ask spreads and/or liquidation costs), as well as the conditions that would trigger the use of a different valuation model (e.g.: model-based valuation). Valuation policies and procedures should also map the cases where valuation uncertainty (e.g.: reliable market prices not available, valuation of certain underlying assets not possible) may trigger the use of Liquidity Management Tools (LMTs – e.g.: swing pricing, suspension of redemptions) to ensure that managers take appropriate actions.

V. ESMA is concerned by the adverse finding reported by a number of NCAs regarding the lack of systematic incorporation of the outcome of LSTs in the context of the valuation of assets under stressed market conditions – particularly for less-liquid assets – and that in some instances there was only a vague or unclear description of whether and how LSTs were considered in the valuation of assets.

VI. As already indicated in the context of the follow-up work to the ESRB Recommendation, ESMA stresses the importance of ensuring that the results of the LSTs help prepare for a stressed market event and are always taken into account when considering the liquidation cost and valuation of less-liquid assets. ESMA strongly encourages market participants to ensure that the LST scenarios also consider the lessons learned from recent market events (e.g.: the Covid-19 pandemic) when setting liquidation costs of less-liquid assets, as well as the conditions around the shift to mark-to-model portfolio valuations. The current economic environment, characterised by a deterioration of the macroeconomic

[13] See ESMA and NCAs find room for improvement in funds' liquidity stress testing (europa.eu). For additional information, see footnote 5 of this Report.

outlook, combined with the tightening of financial conditions, heightened inflation and increased interest rates level, compounds challenges for ensuring a fair valuation of assets at all times and especially under stressed market conditions, which is why funds' portfolios should be regularly stress tested against all extreme but plausible market conditions.

6 Independence of the valuation function and use of external valuers

28. Broadly, NCAs have reported that managers ensure the functional independence of the valuation function, as prescribed by the relevant provisions under the AIFMD framework, but this is not always formalised in the relevant policies and procedures. In this context, NCAs reported four different approaches applied by managers in order to ensure this independence: i) valuation function separated both from the portfolio management and the risk management function; ii) valuation function within the risk management function; iii) valuation function delegated to an external party; and iv) combination of different approaches depending on the type of asset/asset class.

29. A number of NCAs noted that managers have set up specific bodies – such as valuation committees – aiming at ensuring the independence of the valuation function. In some instances, valuation issues are addressed through an internal valuation committee which includes members of the management board, as well as representatives of risk management, valuation, compliance and other departments involved in the valuation of assets.

30. A weakness detected during the CSA exercise is that the roles and responsibilities of the functions involved in the valuation of assets (e.g.: valuation committees) are not always formalised in policies and procedures and the independence of the valuation function is not consistently verified. The results of the analysis also show that while larger managers demonstrated to have good structures in place, smaller managers, in some instances, appeared to over-rely on external data providers for the pricing of less-liquid assets, without performing the appropriate checks, controls and back testing, even when their internal policies and procedures provide for the possibility to use internal models.

31. NCAs were also asked to report on the independence of external valuers, their sufficient professional guarantees, adequate technical resources, and mandatory professional registration. While the majority of NCAs reported a limited use of external valuers by the managers in scope of the exercise, the ones that confirmed their involvement highlighted that due diligence was performed, in compliance with the relevant regulatory provisions, in particular, those relating to the independence,

professional registration and adequate skills. Some NCAs also reported additional specific requirements in their jurisdictions, such as contractual obligations to appoint external valuers for the valuation of specific asset classes (e.g.: real estate), or specific accreditation certificates.

32. In terms of remuneration, the majority of NCAs reported that generally there is no link between the remuneration of the valuation function and the performance of the fund(s). However, one NCA spotted a potential conflict of interest in the case of one manager delegating the valuation function to the same entity in charge of NAV computation, with the remuneration of the latter defined in terms of an all-inclusive fee linked to the NAV which could incentivise a higher asset valuation.

ESMA views

VII. ESMA stresses the importance of clearly specifying the internal allocation of operational tasks and responsibilities for asset valuation and that effective safeguards are in place to ensure the independence of the valuation function, particularly from the portfolio management function.

VIII. ESMA would like to draw NCAs' attention to the importance that the remuneration policy and other measures ensure that conflicts of interest are mitigated, and that undue influence on the employees involved with the valuation of assets is prevented.[14] In this context, ESMA would like to draw attention also to conflicts of interest management where valuation-related functions are performed by third parties (including other group entities), in particular conflicts of interests stemming from third parties performing multiple potentially conflicting functions on a delegation basis and fee structures linked to the NAV.[15] These conflicts of interest measures and safeguards become even more important in case of stressed market conditions, in order to avoid that staff performing valuation functions and external valuers are incentivised to artificially increase the valuation of the assets and/or provide prices which are not aligned with the real conditions of the market.

IX. ESMA highlights the importance of performing an independent analysis on the prices of the assets in the portfolio, especially on less-liquid assets, to ensure that valuation methodologies are robust, based on reliable data and/or verifiable assumptions, particularly under stressed market conditions. It should be avoided to over-rely on the assessment made by external data providers, whose pricing methodologies and outputs should be challenged and regularly back tested in

[14] See Art. 19(4)(b) AIFMD.
[15] See, in particular, Art. 80 AIFMD Level 2 Regulation.

order to ensure their accuracy and robustness under all market conditions. The criteria behind the selection of pricing sources should be duly justified and appropriately documented in valuation policies and procedures.

X. In this context, internal valuation models could be used to challenge the prices provided by the external data providers, at least for the most relevant assets to which the fund is exposed, particularly where the use of these models is already foreseen in the valuation policies and procedures. Internal valuation models should be preferred to external pricing sources, particularly for big-sized managers managing funds invested in less-liquid assets.

7 Early detection mechanisms for valuation errors and transparency to investors

33. NCAs were asked to report on the mechanisms implemented by fund managers for early detection of incorrect NAV calculations and valuation errors, as well as the relevant remedial procedures. While NCAs' feedback suggests that fund managers have early mechanisms in place for the detection of errors, the related remedial procedures are not always sufficiently formalised in the relevant valuation policies and procedures. In addition, the majority of NCAs reported that fund managers often did not calculate the NAV internally but relied on third-party administrators, which were often part of their depositary's group.

34. NCA reported that there is a high level of compliance of managers with the provisions aimed at ensuring early warnings and to detect valuation errors, which are generally based on a two-stage control, the first one performed by the third-party administrator, and a subsequent escalation to the fund manager in case an unusual valuation is reported.

35. NCAs have also reported that most managers have procedures in place that are triggered in case of material harm to investors due to incorrect valuations. Such procedures typically begin with the fund revaluation, recalculation and resettling of the affected transactions, followed by investors compensation (most managers have thresholds in place above which investors are compensated, measured as a percentage of the NAV).

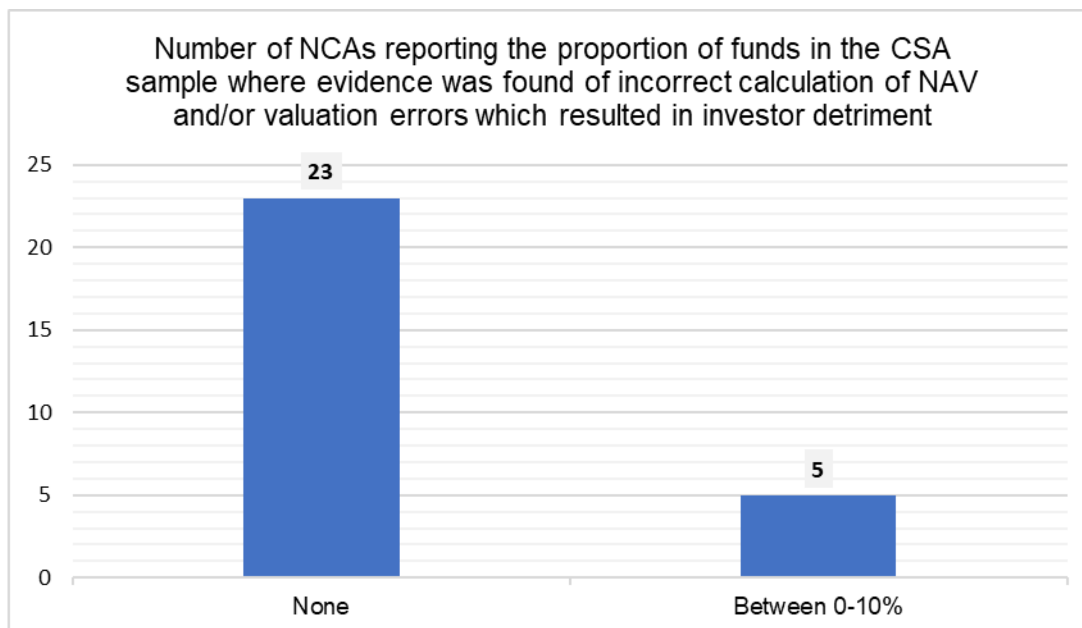
36. One NCA found isolated cases of inconsistencies between the fair value of assets established by the manager and the calculation made by the depositary, due to deficiencies in the calculation that had been identified in the course of a subsequent verification conducted by the depositary. These deficiencies were rectified before publishing the NAV, with no material harm suffered by investors.

37. According to the majority of NCAs, information related to valuation methods/ methodologies are provided to investors both on an ex-ante and ex post basis and NCAs were broadly satisfied with the quality of the disclosure.

38. Overall, only a low number of incorrect NAV calculations and/or valuation errors which resulted in investor detriment were detected by NCAs, in the course of the CSA exercise. Furthermore, in most cases where valuation errors caused harm to investors, NCAs confirmed that supervisory actions were planned to ensure investors compensation.

39. In this context, the results of the CSA survey (see Table 4) show that, among the five NCAs that observed a proportion between 0-10% of the funds in the CSA sample (i.e. number of funds/total number of funds in the sample) where incorrect calculation of NAV and/or valuation errors caused investor detriment, four NCAs are planning to take supervisory action to ensure investor compensation.

Table 4



ESMA views

XI. ESMA stresses the importance of ensuring full investor compensation in all cases where valuation errors caused harm to investors. Formal remedial procedures should be in place in the event of valuation errors and incorrect calculations of the NAV, in line with the applicable regulatory provisions. The prompt activation

of such measures and correct execution should be stringently monitored, in particular in case of stressed market conditions.

XII. NCAs should verify that valuation policies and procedures, including governance arrangements and any changes to methods/methodologies in the asset valuation and NAV calculation, is appropriately disclosed to investors. Disclosures should be clear and avoid overly technical language. Equally, investor disclosures should avoid the use of overly general or boilerplate language that does not allow the investors to understand the actual valuation methods/methodologies used and valuation risks faced.

XIII. Where the internal control functions and/or external controls by depositaries/auditors failed to identify valuation-related issues, ESMA encourages NCAs to follow up on those findings and take appropriate actions, particularly in case the depositary failed to comply with its oversight obligations to, *inter alia*: i) verify on an ongoing basis that appropriate and consistent procedures are established and applied for the valuation of the assets; ii) ensure that the valuation policies and procedures are effectively implemented and periodically reviewed; iii) where it considers that the calculation of the value of the shares or units of the AIF has not been performed in compliance with applicable rules, ensure that timely remedial action is taken in the best interest of the investors; and iv) where an external valuer has been appointed, check that the external valuer's appointment is in accordance with applicable rules.

8 Focus on funds investing in private equity and real estate assets

40. In light of the broad variety of less-liquid assets in which UCITS and AIFs can invest, ESMA provided NCAs with the discretion to focus the CSA exercise on a selected subset of funds, taking into account the specificities and actual or potential valuation risks faced in their relevant market.

41. Several NCAs have focused their analysis on PE and RE assets, in light of the specific valuation and liquidity risks posed by the funds invested in those asset classes.

42. Although most NCAs reported that no specific regulatory breaches were identified in the course of the CSA exercise, several NCAs highlighted room for improvement in the following areas, especially for PE and RE funds:

a) the misalignment between the availability of up-to-date data and the valuation frequency (e.g.: asset valuations are not aligned with the frequency of

availability of data inputs/prices, financial statement of the underlying companies of PE funds not immediately reflected in the funds' valuation);

b) high level of discretion for the selection of the valuation models;

c) potential conflicts of interest due to the portfolio managers' influence on the valuation process (e.g.: by means of providing key input to the valuation models);

d) application of valuation discounts not sufficiently documented and duly justified.

43. Against this background, a few NCAs decided to gather additional quantitative fund-level data. The results of their analysis are described in the following sections.

Private Equity and Real Estate funds

44. One NCA focused on open-ended PE funds, considering the relative newness of this type of fund in the national market, as well as its similarities with ELTIFs allowing redemptions during the life of the fund in light of the revised ELTIF Regulation[16]. This NCA used the results of the CSA exercise related to open-ended PE funds to further reflect and potentially shed light on some of the issues that may arise with ELTIFs allowing redemptions during the life of the fund, following the review of the ELTIF Regulation. The main challenges identified by this NCA related to the ability to regularly value the illiquid assets[17], as well as to the appropriateness of the LMTs in place to ensure the equal treatment of investors. According to the NCA, the outcome of the analysis justifies an increased scrutiny of open-ended funds invested in less-liquid assets and suggests the inclusion of strict valuation provisions in the context of the ELTIF review.

45. More broadly, the issue around the alignment between the NAV calculation, the asset valuation frequency and the availability of up-to-date data is particularly relevant for funds invested in less-liquid assets. The valuation and liquidity risk are further amplified in the case of open-ended RE funds offering frequent redemptions, which are

[16] Publications Office (europa.eu).
[17] The analysis of the NCA shows that PE investments are generally fully (re)valued every quarter or every semester on the basis of the official accounting information provided by the target company. Between the valuation dates the manager keep the valuation unchanged in the absence of new information. This has two main consequences: 1) the stable valuation between different valuation dates does not seem to be reliable and 2) jumps are observed at the valuation dates.

intrinsically exposed to liquidity mismatches due to the illiquidity of their assets, as also highlighted, inter alia, by the December 2022 ESRB Recommendation.[18]

46. More specifically, with regard to the valuation of underlying RE assets, NCAs highlighted the heavy reliance on long-term models, which hardly take into account sudden events or crisis scenarios (e.g.: the Covid lockdowns) or the specific characteristics linked to the asset class (e.g.: vacant estates, tenants' credit difficulties). The analysis regarding RE funds, predominantly based on discounted cash flow and capitalisation valuation models, confirmed that the impact of Covid-19 on the underlying RE valuations was limited, given the fact that models are based on long-term assumptions and do not always take into account asset specificities and market trends.[19] Against this background, risks arise in light of the heavy reliance on long-term models which may result in stable valuations that are not always sufficiently adapted/reactive to changing market scenarios. As also indicated by the December 2022 ESRB Recommendation, it is important to improve the monitoring of the vulnerabilities stemming from the real estate sector that could be a source of risk to financial stability, particularly under the current economic conditions characterised by a heightened inflation and the deterioration in the growth outlook.[20]

47. As previously highlighted [21], ongoing supervision should continue to focus on potential liquidity mismatches and inaccurate valuations, with a particular attention to funds invested in less liquid asset offering frequent redemptions.

ESMA views

XIV. As already indicated in its Report in response to the May 2020 ESRB Recommendation, ESMA stresses the importance of ensuring ongoing supervision of the alignment between the funds' investment strategy, liquidity profile and redemption policy. In this context, ESMA reiterates its concern about

[18] "One of the vulnerabilities for the non-banking sector is liquidity mismatches in open-ended real estate investment funds. This liquidity mismatch occurs when such funds offer redemption periods to their investors that are shorter than the period necessary to liquidate at current market prices the real estate assets that the fund has invested in. Real estate investment funds generally are also at risk of an asset price correction if the frequency of valuation is too low and there are incentives to overvalue property, particularly in a market where prices are already decreasing. This can, in turn, lead to cliff effects in asset redemptions". See Recommendation of the European Systemic Risk Board of 1 December 2022 on vulnerabilities in the commercial real estate sector in the European Economic Area (ESRB/2022/9) (europa.eu), paragraph 8.

[19] This result is in line with the outcome of the ESRB exercise which showed that despite having structural liquidity mismatches due to the illiquid nature of their assets, the real estate funds in the sample appeared to be globally relatively resilient during the COVID-19 related market stress in February and March 2020. For instance, none of them were suspended during the period and they maintained their liquidity buffer. See the ESMA Report in response to the 2020 ESRB recommendations, available at esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf (europa.eu), p. 54

[20] See Recommendation of the European Systemic Risk Board of 1 December 2022 on vulnerabilities in the commercial real estate sector in the European Economic Area (ESRB/2022/9) (europa.eu)

[21] See esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf (europa.eu), in particular, Priority Area 1 set out therein.

potential structural liquidity mismatches of funds investing in less-liquid assets offering frequent redemptions (e.g.: open-ended RE funds), in light of the provision under the AIFMD aimed at ensuring consistency between the liquidity profile and the redemption policy.[22]

XV. ESMA is concerned about the variable degree of objectivity in the selection of valuation methodologies for less-liquid assets and their underlying assumptions, which can result in not sufficiently reliable and/or incorrect valuations and can create situations of unfair treatment of investors.

XVI. ESMA would like to stress the importance of a proper assessment of data quality and financial models used by mark-to-model valuation by the manager and that the assumptions behind the models are robust and periodically back tested.

XVII. In line with the December 2022 ESRB Recommendation[23], ESMA encourages NCAs to monitor and assess the state of preparedness for an unexpected increase in redemptions and/or an increase in valuation uncertainty for open-ended RE funds.

9 Follow-up actions envisaged by NCAs

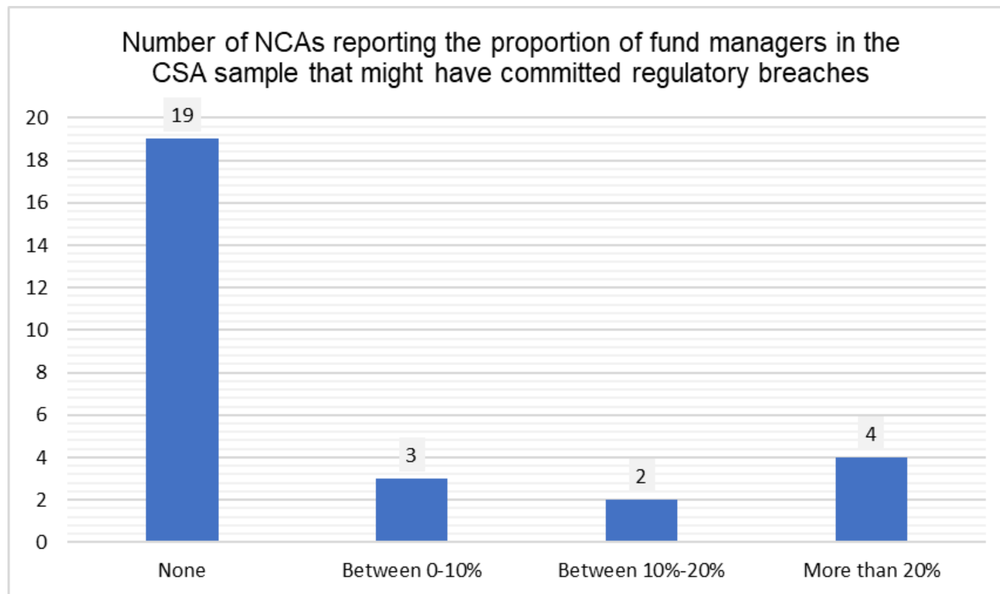
48. NCAs were asked to report on the follow-up actions that they plan on taking following the CSA exercise.

49. Most NCAs considered that there is an overall satisfactory level of compliance of supervised entities with the applicable regulatory requirements, and did not identify any severe regulatory breaches, but rather a number of shortcomings and vulnerabilities. Where such shortcomings and vulnerabilities were identified, the relevant NCAs have planned follow-up actions to ensure a timely remediation of the identified deficiencies. These NCAs stated that identifying clear-cut regulatory breaches proved to be challenging in relation to UCITS given the lack of specific regulatory provisions.

50. This is in line with the outcome of the CSA survey which shows that only nine NCAs identified potential regulatory breaches (see Table 5).

[22] See Article 16(2) of AIFMD Level 1.
[23] See Recommendation of the European Systemic Risk Board of 1 December 2022 on vulnerabilities in the commercial real estate sector in the European Economic Area (ESRB/2022/9) (europa.eu).

Table 5



51. In relation to the regulatory breaches identified, most NCAs have stated that they do not plan to take enforcement actions or to impose sanctions. Only one NCA reported an administrative sanction imposed in the context of the CSA exercise for some breaches already detected in previous inspections and which were related to the independence of the valuation function, the use of wrong prices, lack of prices' evidence and control, as well as valuation of assets which were not in line with the valuation policy and the information provided in the prospectus. A few NCAs spotted isolated cases of valuation/NAV errors which have been rectified and, in case of material harm, investors were fully compensated.

52. Against this background, 26 NCAs are not planning to refer any case to enforcement since the underlying issues have been mostly rectified. Two NCAs confirmed that they envisage enforcement actions for a total number of seven cases, as shown by the results of the CSA survey (see Table 6).[24]

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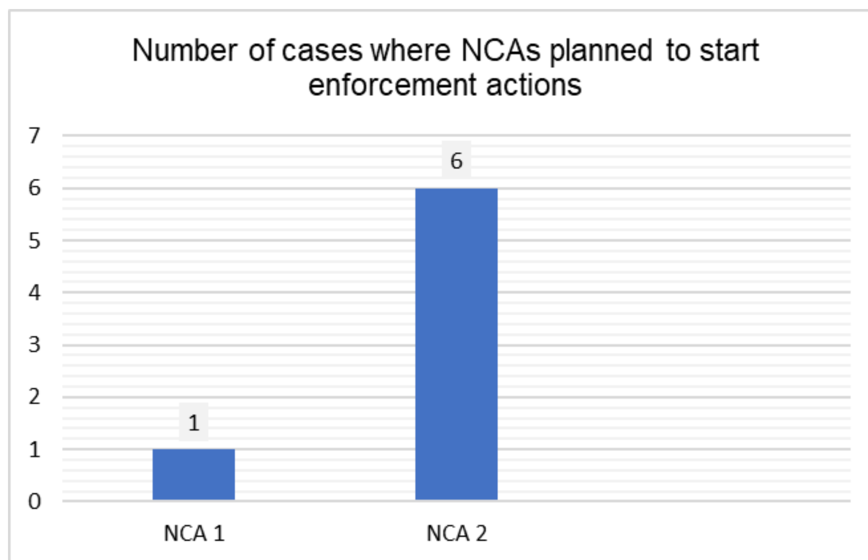
[24] The chart only includes the information regarding the enforcement actions planned by the NCAs that participated to the survey.

Table 6



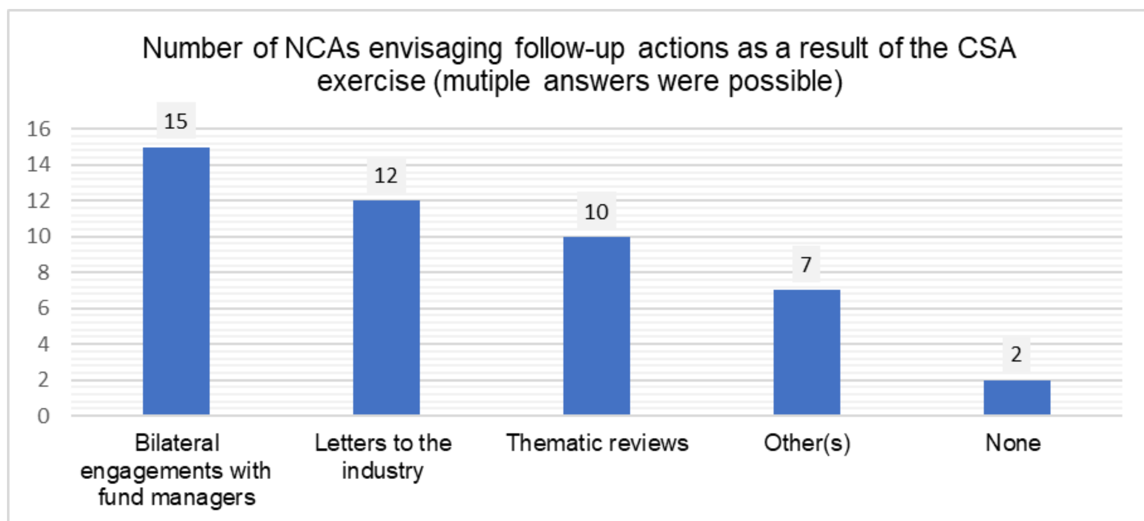
53. The majority of NCAs highlighted that they have followed up/are going to follow up on the CSA's main findings, by means of bilateral exchanges with the relevant fund managers to ensure that the identified risks are properly addressed, and timely mitigation actions are put in place.

54. Many NCAs highlighted that the results of the CSA will play an essential role in the upcoming follow-up actions and some of them plan to issue a public report on the outcome of the CSA exercise aimed at identifying best market practices. In addition, some NCAs plan to send individual letters to managers outlining areas of improvement, as well as organising bilateral meetings with managers where adverse supervisory findings were identified. Other NCAs plan to prepare industry letters/circulars to improve market standards and address the identified shortcomings as part of thematic reviews, with recommendations on some specific topics (e.g.: valuation of hard-to-value assets, valuation frequency and the controls over the external valuation function). A few NCAs indicated that the final decision on the types of follow-up actions has not yet been taken.

55. The CSA survey provided a complete overview of the envisaged follow-up actions and confirmed that bilateral engagement with fund managers is the preferred approach used by NCAs to address the adverse findings identified in the course of the CSA exercise, followed by letters to the industry and thematic reviews. Among the other approaches, some NCAs also envisage to follow up with on-site inspections, dedicated

discussions in form of workshops, additional investigations, and other corrective measures.

Table 7



ESMA views

XVIII. As highlighted in previous occasions, ESMA acknowledges NCAs' general preference to use escalated supervisory measures instead of taking enforcement measures.[25] In this context, ESMA reiterates the importance of using the full range of the supervisory and enforcement toolkit they have been provided with by the applicable legal framework. This is particularly important in light of the requirement under both the UCITS and AIFMD frameworks for Member States to ensure the existence of sanctions that are "*effective, proportionate and dissuasive*". Against this background, ESMA would like to encourage NCAs to consider the use of sanctions in case of significant regulatory breaches, as well as ensuring investors compensation in case valuation errors caused a financial detriment to investors.

XIX. In light of recent market events, which have shown the importance of ensuring a fair valuation of assets both under normal and stressed market conditions, as well as the current deteriorated economic scenario, ESMA also stresses the

[25] See, for instance, the 2021 UCITS and AIFMD sanctions reports available at esma34-45-1647_2021_ucits_sanctions_report.pdf (europa.eu) and esma34-463-941_2021_aifmd_sanctions_report.pdf (europa.eu) and Section VIII of the 2021 CSA Final Report, available at esma34-45-1673_final_report_on_the_2021_csa_on_costs_and_fees.pdf (europa.eu).

	importance of an active monitoring of the quality of the valuation of funds' portfolios and welcomes that NCAs have planned to follow-up on the deficiencies identified in the course of the CSA.