LESSONS FROM COVID REGARDING THE EU FUND SECTOR'S RESILIENCE

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1. The debate about fund liquidity risks has been revived by the Covid crisis

Liquidity issues experienced by some investment funds in March and April 2020, as well as previous events in 2019 related to the collapse of Woodford Investment Management or H2O AM have revived the debate about fund liquidity and resilience, which was a key concern after the 2008 financial crisis.

Although the European fund sector generally demonstrated resilience during the market stresses of March-April 2020, liquidity mismatches in the set-up of certain funds were amplified by a deterioration of the liquidity of their underlying assets combined with significant investor redemptions. Some industry players have however emphasized that although these redemptions were high in nominal terms, they remained at manageable levels when viewed as a percentage of fund assets under management (AuM). The funds concerned are certain open-ended funds that invest in potentially less liquid and / or more risky assets, such as corporate high yield and emerging market bonds[1] or real estate[2], and offer high redemption frequency with no or short notice periods. The fact that some of these funds had low liquid asset buffers before the crisis has also been stressed by some regulators. Some market players have pointed out however that the buffers measured only include cash and government bond holdings whereas these funds may sell a wider range of securities to weather a market shock or manage large outflows and thus do not rely on liquidity buffers per se for meeting redemptions[3]. Other influences on market dynamics that have also been highlighted include the drop in equity prices that led to portfolio rebalancings from fixed income into equities, leverage used by volatility-targeting funds[4] and loan covenants for real estate funds that may have triggered fire sales.

The data collected by ESMA[5] in response to a recommendation of the ESRB[6] show that the vast majority of EU corporate debt and real estate funds were able to meet redemption requests and maintain their portfolio structure during the Covid events of 2020 and quickly recovered. Only a limited number of funds were obliged to suspend redemptions (0.4% of the ESMA EU corporate debt funds sample in March). ESMA's data also show that redemption suspensions were mainly motivated by material valuation uncertainty and insufficient market liquidity of some underlying market segments, rather than outflows. While redemptions from funds picked up towards the end of March, they shortly afterwards reversed into inflows, as significant central bank interventions[7] improved investor confidence in bond markets, in the absence of sufficient market-making activity, and as fiscal policy helped to support debt issuers through the first stages of the pandemic. Some Liquidity Management Tools (LMT) also played a role in the management of redemptions. Approximately 25% of corporate debt funds of the sample analysed by ESMA used swing pricing[8] in order to treat remaining investors fairly. Temporary borrowing was also used by approximately 10% of these funds.

Many EU money market funds (MMFs) were also affected in March 2020 by high levels of redemptions from their investors close to the levels seen in the 2008 financial crisis (10 to 20% of holdings during the most stressed period in March)[9],

1. For example high-yield corporate bond funds experienced significant outflows of more than 10% of their assets under management during the first quarter of 2020. Source ECB, speech by I. Schnabel 19 November 2020. The liquidity of certain corporate bond markets practically disappeared during that period or costs of transacting rose significantly.
2. Only certain jurisdictions such as the UK allow real estate funds to use an open-ended structure with daily redemptions.
3. This is backed by ESMA analysis showing that corporate bonds were able to meet redemptions by vertical slicing, thereby maintaining a consistent liquidity profile
4. i.e. contractual obligations relating to the loans received.
5. ESMA report on the Recommendations of the ESRB on liquidity risks in investment funds – 12 November 2020.
6. Recommendation of the ESRB on liquidity risks in investment funds (ESRB/2020/4).
7. The ECB expanded its asset purchase programme (APP), extending eligibility for the corporate sector to commercial-paper of select non-financial corporates. A € 750 Bio Pandemic Emergency Pandemic Programme (PEPP) was put in place targeting all assets under the APP i.e. commercial paper, corporate bonds, covered bonds and public sector securities and without conventional country-level and maturity restrictions. Additional liquidity support was given by the ECB through a 25 bp curb on an expanded TLTRO III programme, extending financing to banks linked to household and non-financial corporate lending followed by a relaxation of collateral acceptability criteria (including Greek government debt and "fallen angel" corporate bonds) and additional emergency longer-term refinancing operations.
8. The objective of swing pricing is to protect existing investors from the dilution of value caused by trading costs resulting from subscription and redemption activity on the fund. Swing pricing allows the fund sponsor to adjust the price of a fund unit using a parameter, known as the "swing factor", which incorporates an estimate of the bid-ask spread, so that all investors who deal on a given dealing day bear the cost of transactions to meet their redemptions (or subscriptions) if there are large outflows or inflows.
9. On the liability side, investor redemptions peaked in the second part of March, with outflows totalling 20% of LVNAV MMF holdings and more than 10% of VNAV MMFs in some EU countries (Source Speech by S. Maijoor at the EFAMA investment forum). EUR LVNAV saw 16% AUM outflows over most stressed 7 days in March, Sterling -11% over similar period and Dollar -29% over worst 19 days (of which 60% went to Gov Liquidity CNAV). Looking at the whole month of March EUR VNAV and LVNAV both saw 14/15% outflows (source: Central Bank of Ireland and Central Bank of France).

combined with a deterioration of the liquidity of commercial paper (CP) markets on the asset side[10].

This asset outflow concerned particularly USD denominated Low Volatility NAV MMFs (LVNAVs)[11] and EUR denominated Variable NAV MMFs (VNAVs), whereas Constant NAV MMFs (i.e. CNAV funds that are quasi-exclusively exposed to sovereign debt) benefitted from inflows, due in part to a 'flight-to-safety' in particular for those in US dollars. Two other underlying drivers of MMF redemptions were an increase in CCP margin calls that led market participants who faced liquidity pressures to withdraw liquidity from MMFs in order to meet these margin calls and redemptions by non-financial companies seeking to meet their operational cashflow needs in the Covid context.

Many LVNAVs in the EU were able to meet redemptions through the market turmoil in part by selling securities in the secondary market. Where lack of dealers did not allow that, cash was retained from maturing securities[12] (rather than reinvesting in new CP/CD paper). Only a small number of LVNAVs dipped below their mandated 30% weekly liquidity buffers and none were forced to impose redemption gates or liquidity fees.

For VNAVs that did not have such requirements linking liquidity buffers with the possibility of imposing gates and fees, these buffers were a more effective tool for meeting redemptions, although some of them also had to sell securities and stop reinvesting the proceedings of maturing ones to cover redemptions. Central bank interventions were put in place by the ECB, aiming at compensating the lack of market liquidity (widening of asset purchases, liquidity operations, bank refinancing operations and backstop facilities) but these concerned part of non-financial CPs[13] and longer maturity instruments and thus did not benefit most MMFs directly. Regulators and market participants have however considered that these measures helped to restore confidence throughout the system.

With volatility decreasing and the market stabilising, outflows fell from the beginning of April 2020 and have been replaced by inflows since then. In general however, the short term markets in Europe remained stressed for several weeks in contrast to the US where temporary capital requirement relief for dealer banks unblocked the short-term markets.

2. The on-going Covid crisis may lead to further market stress

Although no significant financial stability issues emerged related to investment funds during the first phase of the Covid crisis, many regulators consider that potential vulnerabilities in the fund sector were exposed by the March-April events and need addressing, together with the factors that led to insufficient liquidity of some underlying markets, in order to avoid further distress and central bank interventions. They indeed argue that liquidity issues may have significant consequences for investors if they result in a suspension or a higher cost of fund redemptions and that they may cause systemic spill-overs due to potential fire sales and interconnections within the financial market[14].

The next stages of the Covid crisis could indeed lead to more risks to financial markets. The Covid pandemic may provoke some new periods of market stress in the coming months (e.g. related to virus variants or the effectiveness of vaccination). In addition the current decoupling between market valuations and the real economy may create further volatility episodes. Monetary policy is a second factor. Ultra-low interest rates may spur continued risk-taking from investors in search for yield and foster asset bubbles creating possible market stress. Other elements also need considering, such as the risk of higher inflation in the future or cross-asset correlations that have increased during the first months of the Covid crisis, reducing diversification benefits[15].

Regulators have also pointed out some remaining issues in the fund sector, as mentioned further up. These include potential liquidity mismatches, with up to 90% of corporate bond funds offering daily redemption while investing in less liquid assets and 42% of real estate funds, according to ESMA assessments and the fact that only a limited number of funds with liquidity mismatches have adjusted their liquidity management processes following the Covid crisis. Other issues that have been mentioned concern the cash holdings of EU corporate bond funds that remain low, despite a temporary increase in Q2 2020, and an increase of the leverage of hedge funds.

The functioning and structure of underlying markets that were distressed during the first episode of the Covid crisis (certain corporate bonds, real estate, short-term markets…) and in particular the challenges associated with market-making activities that had to be compensated by the intervention of central banks are also an essential issue that needs tackling, according to many commentators, as well as the modalities of CCP margin posting.

In addition, the limitations of the tools used for tackling liquidity issues in March / April 2020 need to be considered. The central bank actions that helped to swiftly alleviate market stress through different

10. The fact that the liquidity of money markets is relatively low in normal times also has been mentioned by some regulators. However many market participants stress that while there is low turnover of CP in normal market conditions, this does not necessarily equate to low liquidity (i.e. CP may trade infrequently but normally).

11. Low Volatility NAV MMF can maintain a constant dealing NAV provided the mark-to-market NAV does not deviate from the dealing NAV by more than 20 bps

12. Source: Thematic note 'MMFs during the March-April episode' – IOSCO November 2020.

13. Only non-financial companies that were rated by ECB approved CRAs were eligible (e.g. not those rated by all ESMA-approved CRAs).

14. These regulators consider that mismatches between the liquidity of open ended funds and their redemption profile may lead to fire sales to meet redemptions, potentially amplifying market stress and affecting other financial market participants holding the same or correlated assets, given that investment funds hold a significant proportion of the stock of some less liquid securities in the EU such as non-financial corporate bonds or commercial real estate. The interconnections that exist between MMFs and the financial system are also pointed out by regulators since MMFs play a significant role in the short term funding of banks and CCP participants hold liquidity positions in MMFs that they may sell to post margin in cash.

15. Source IMF: Global financial stability report October 2020.

channels may create moral hazard and foster the wrong incentives in terms of risk management, if they are systematically reproduced. Secondly, the present variability in the availability of liquidity management tools (LMTs) across member states means that these tools are not as effective as they could be to mitigate these risks. Some observers however stress that they are already quite widely available notably in the 4 main EU fund domiciles (Luxembourg, Ireland, France and Germany) and widely operationalised in the EU's primary cross-border fund domiciles.

3. Fund liquidity rules have been updated since the 2008 financial crisis

EU fund frameworks contain a wide range of liquidity rules that are complemented by international recommendations developed by IOSCO, as well as liquidity management tools (LMTs) available at domestic levels in the EU. Concerns were however repeatedly expressed by supervisors and regulators about the build-up of potential liquidity mismatches in investment funds before the Covid crisis, raising the question about whether liquidity rules are complied with in practice by all funds in the EU.

3.1. Existing UCITS and AIFMD liquidity requirements and domestic LMTs

The UCITS and AIFMD directives both contain liquidity management requirements that aim at ensuring the fund's ability to meet investor redemption requests according to the fund rules, in a manner consistent with the fair treatment of all investors[16].

AIFMs are required to maintain consistency between the investment strategy, redemption policy and the liquidity profile of their AIFs. Mandatory disclosures to regulators and investors also cover liquidity risk. For example, the details concerning the liquidity profile of each AIF must be shared with the National Competent Authorities (NCAs) and fund inventories must also be reported to the central bank in Eurozone Member States. Investor disclosures must also include information on illiquid assets, liquidity arrangements that can be potentially used by AIFs such as gates or side pockets and on redemption rights. Both AIFMs and UCITS managers under ESMA's stress testing Guidelines, most recently updated with effect from September 2020, must conduct regular stress tests of the funds they manage under both normal and exceptional liquidity conditions assessing both asset and liability risks and the results of these stress tests must be shared with NCAs.

Management companies are also required to employ an appropriate liquidity management process in order to ensure that the UCITS they manage are able to comply at any time with allowing investors to redeem their units on demand. This includes ensuring that the liquidity profile of the investments of the UCITS is appropriate to the redemption policy laid down in the fund rules and also conducting regular stress tests. UCITS may also temporarily suspend redemptions in the interest of unit holders under certain conditions. In addition, UCITS are subject to detailed eligibility rules that govern the types of assets in which they are allowed to invest and that limit exposures to derivative instruments and concentration with counterparties.

Following recommendations made by the ESRB in December 2017[17] on liquidity and leverage risks in investments funds, ESMA has complemented UCITS and AIF liquidity rules with guidelines on stress testing in order to support the regular testing of the resilience of funds to liquidity risk under normal and exceptional liquidity conditions. ESMA has moreover undertaken different supervisory actions in connection with the NCAs with regard to liquidity risk including: a stress simulation exercise (STRESI) combining asset liquidity and redemption shock simulations (which showed vulnerabilities among about 10% of EU fund) and a common supervisory action as well as a data collection exercise on liquidity risk management.

LMTs such as gates, swing pricing or side-pockets are also accessible at the domestic level for managing fund liquidity risks, both for UCITS and AIFs. These tools are already used by investment funds in the EU when needed, since they are available in the main EU fund domiciles, but their availability varies across jurisdictions and they are not standardized at the EU level. At present, the suspension of redemptions is the only LMT that is available to all funds in all jurisdictions.

A final element that needs considering is that the design and features of all regulated funds (UCITS and AIFs managed by regulated AIFMs) including their liquidity features, have to be submitted for authorisation to the regulator of the fund domicile, who also ensures the monitoring of risks and investor protection on an on-going basis.

3.2. MMF liquidity rules

As for MMFs, they are mostly structured as UCITS in the EU and therefore come under the liquidity rules mentioned above. A specific MMF regulation (MMFR) was moreover adopted in 2017 aiming to improve the resilience of MMFs. MMFR limits the use of a constant NAV to MMFs investing at least 99.5% of their assets in public debt and has created a new type of MMF (Low Volatility NAV MMF) which can maintain a constant dealing NAV provided the mark-to-market NAV does not deviate from the dealing NAV by more than 20 bps.

Beyond the definition of fund structures, MMFR also introduced liquidity requirements including daily and weekly liquidity buffers which vary across the different fund structures and specific provisions around liquidity fees and redemption gates completing UCITS provisions (fund boards are required to take a decision as to whether to use these tools when breaches of the minimum weekly liquidity levels, coupled with 10% daily outflows from the fund are observed). The MMFR also contains risk management requirements imposing internal processes to monitor credit quality, portfolio diversification, maturity thresholds and KYC procedures. Stress testing, the guidelines for which have recently been updated by ESMA, is also mandatory and has been implemented by EU fund management companies.

16. The UCITS and AIFM directives also provide a legal basis for limiting the build-up of leverage in investment funds.

17. Recommendation of the ESRB of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6).

In addition, transparency requirements are imposed notably regarding portfolio holdings and their liquidity for informing investors and NCAs.

3.3. International fund liquidity guidelines

At the international level, recommendations were introduced by IOSCO in 2018 for addressing liquidity risks from asset management activities, following work conducted by the FSB on vulnerabilities from market-based finance activities. These recommendations are broadly consistent with EU fund liquidity rules. A thematic review of these rules was launched in March 2021 by IOSCO aiming at gathering information about how they were implemented by the responsible entities.

The objective of these IOSCO recommendations, which concern the design of funds, their day-to-day liquidity management and contingency planning is to make sure that asset managers are prepared for and are able to adapt to a constantly changing market environment and potential liquidity risks.

IOSCO therefore recommends that "responsible entities" for fund management should include liquidity risk management processes and tools in the design of their funds (e.g. appropriate liquidity thresholds, suitable dealing frequency, appropriate subscription and redemption arrangements, liquidity aspects related to its proposed distribution channels…) and integrate liquidity management in investment decisions. The responsible entity should moreover monitor the performance of its liquidity risk management process, regularly assess the liquidity of the assets held in its fund portfolios, perform regular fund level stress testing and identify any emerging liquidity shortage risks. In addition, IOSCO recommends that entities should determine whether or not and also how to possibly activate additional liquidity tools and also put in place contingency plans to ensure that liquidity management tools can be used if needed.

4. Proposals for improving fund liquidity risk management in the EU

Many regulators are calling for a stricter enforcement of existing fund liquidity rules as well as a review of these rules in the light of the latest Covid-related events. Suggestions have also been made that a broader macro-prudential framework should be put in place for investment funds.

Reinforcing the resilience of the NBFI sector and addressing potential vulnerabilities related to liquidity mismatches, leverage and interconnectedness is also an objective put forward at the international level by the FSB, following the Covid events.

4.1. UCITS and AIFMD liquidity rules and tools

ESMA has identified five priority areas for further enhancing the preparedness of corporate debt and real estate funds in particular to potential future redemption and valuation shocks[18].

Three of them relate to an improved implementation and supervision of key liquidity provisions of the UCITS and AIFMD frameworks i.e. (i) the requirement to align the fund's investment strategy with the redemption policy; (ii) the quality of the liquidity risk assessment; and (iii) valuation processes in a context of valuation uncertainty. Asset managers are encouraged to step up their efforts to ensure that the relevant requirements are adequately complied with. NCAs are also asked to pursue the ongoing monitoring of compliance with these rules, particularly concerning any corporate bond and real estate fund that has been identified as being in breach with EU requirements following the on-going data collection exercise conducted by ESMA.

In its 2017 Recommendation, the ESRB has also stressed the need for open-ended AIFs to align the fund's strategy with the redemption policy. This recommendation concerned corporate debt and real estate funds, but also funds investing in unlisted securities, loans and other alternative assets[19].

Some commentators have emphazized that the alignment of investment strategies and redemption policies must in priority be achieved in the design and registration phase of funds during which asset managers and NCAs must ensure that the fund characteristics and rules are consistent. Moving away from daily dealing also raises commercial and technical challenges that need addressing. Retail investors tend to prefer liquid funds and advisors are likely to recommend daily dealing funds. Moreover, most fund trading platforms work on the basis of daily dealing[20]. Alternatives include imposing stricter conditions for daily dealing to be possible (e.g. financial penalties that have been proposed for maintaining daily redemptions of real estate funds in the UK; use of liquidity management tools when needed) and for them to be explicitly communicated to investors, as well as improving the functioning and liquidity of the underlying market segments.

The two other priorities proposed by ESMA involve additional regulatory requirements that could be implemented in the context of the AIFMD review underway.

The first proposal is to develop a harmonised legal framework at EU level regarding LMTs in both UCITS and AIFMD frameworks, in order to increase their availability and use across the Union, without necessarily standardising the tools or the way they are used. This proposal was also part of the 2017 ESRB recommendation, which was addressed to the European Commission[21]. Some industry players however point out that LMTs are already widely available in the main EU jurisdictions for fund registrations (i.e. Luxembourg, Ireland, France, Germany) and that an EU framework with more prescriptive rules may reduce the flexibility that is needed in using them. Some industry representatives have also suggested that efforts should

18. Source Speech by S. Maijoor EFAMA investment forum 2020.

19. Recommendation B of ESRB/2017/6.

20. FT 22 June 2020 – Fund suspensions underline liquidity mismatches and ESMA's report (November 2020 – see above).

21. Recommendation A of ESRB/2017/6.

focus on certain LMTs that have limited procyclical effects, such as swing pricing, which ensures that transacting investors bear the cost of liquidity, thereby incentivising requests to be spread over a number of days and removing first mover advantage potential [22].

The second proposal put forward by ESMA relates to the establishment of specifications on how fund profiles should be established and reported, concerning notably the percentage of a fund portfolio that can be liquidated and arrangements with respect to gates and notice periods, in order to support a risk-based supervision of liquidity risks.

4.2. MMF rules

Further areas of improvement have been put forward regarding MMFs. Following its recent assessment of Covid events, ESMA emphasized the importance of stress tests and ensuring that they are systematically conducted according to ESMA guidelines and that scenarios used and results obtained are centralised via the NCAs. Several areas of potential reform of the MMFR to be taken into account in the future review of the regulation have also been identified by ESMA in a consultation launched on 26 March 2021. These potential reforms include: (i) a decoupling of regulatory thresholds from suspensions/gates to limit liquidity stress, and a requirement for MMF managers to use liquidity management tools such as swing pricing; (ii) a review of requirements around liquidity buffers and their use; (iii) a review of the status or an elimination of certain types of MMFs such as CNAV MMFs and LVNAVs; and (iv) an assessment of the need to modify sponsor support rules.

The ECB has moreover suggested that further work on MMFs should focus on enhancing liquidity features and removing incentives for investors to redeem early, considering the unintended side effects of suspending redemptions or imposing gates[23]. Further proposals made by regulators are that MMF liquidity requirements could be alleviated in times of crisis and that the prohibition of sponsor support for MMFs could be reconsidered, given that in the US banks are allowed to provide support to their MMFs.

Industry representatives have however pointed out that the March-April events were mainly due to the absence of liquidity in the underlying money markets and to the significant demand for liquidity simultaneously (e.g. to fund CCP margin requirements) and not to intrinsic flaws in MMF structures. It has thus been suggested that the priority should be to review the functioning of short-term markets, including looking at EMIR rules in order to allow the posting of MMFs as margin, rather than only cash. In addition, while MMFR rules meant that many funds were well-positioned from a liquidity and transparency perspective, many market participants have commented on the need to ensure that liquidity buffers can be used in times of stress by reviewing the requirement to consider redemption fees and gates in case liquidity requirements are breached.

4.3. Macro-prudential toolkit and reporting requirements

ESMA and the ESRB are also supportive of further initiatives to develop the macro-prudential toolkit for investment funds in order to better monitor risks and the interconnectedness of investment funds with the EU financial system and reduce in the future the need for central banks to intervene in a crisis. These tools would complete existing measures that may be used in a macro-prudential perspective such as stress tests, reporting, LMTs and leverage limits. ECB representatives have also suggested that the current macroprudential toolkit should be extended to include ex-ante liquidity management tools such as minimum liquidity or cash buffers and redemption notice periods, as well as a close monitoring of intermediaries' leverage [24].

Although developing a more holistic view of the fund ecosystem and of the connectivity among its different components is generally welcomed, some industry players have emphasized in the past the possible downsides of using certain macroprudential tools such as cash or liquidity buffers or redemption policies at market segment level (i.e. across all or certain categories of funds or asset managers) due to their possible procyclical effects and impacts on end-investors, favouring instead liquidity measures or tools at the individual fund level.

Some regulators have also emphasized the need for more detailed harmonized and consolidated data for achieving this holistic view and also for allowing an appropriate monitoring of investment fund risks at the EU level (e.g. in order to better assess interconnections and risks of asset portfolios). For example at present it is difficult for supervisors to get an appropriate view of the liquidity positions of different fund categories and their recourse to LMTs at EU level. The ESRB has identified several areas where the reporting framework should be improved to allow for an effective monitoring of systemic risks[25]. The ESRB argues that a unique availability of fund identifiers is needed to understand the mapping of the AIFMD data with other sets of data (such as transaction data under the European Market Infrastructure Regulation – EMIR). The granularity of the information provided should also be enhanced as information systems allow to process efficiently big datasets and as a more detailed reporting on investments as well as on investors would be less costly for fund managers, compared to reporting aggregate statistics The need to harmonise UCITS and AIFMD supervisory reporting has also been raised by ESMA in the context of the AIFMD review.

22. Source Blackrock – Lessons from Covid-19: Liquidity risk management is central to open-ended funds – November 2020.
23. ECB Financial Stability Review November 2020. ECB representatives have also suggested that a review of the liquidity requirements of MMFs and their portfolio composition is needed, especially for LVNAV funds. Source speech by Isabel Schnabel, 9 November 2020.
24. Source Speech by Luis de Guindos, 22 July 2020.
25. ESRB response to the European Commission consultation on the AIFMD review, 29 January 2021.

Moreover the fragmentation of fund supervision may hinder an appropriate monitoring of risks, according to certain regulators and the role of central banks in case of systemic financial crisis may also need clarifying[26]. At present, supervision is often shared among several jurisdictions since the management company may be licensed in a different country from where funds are registered and from where portfolio management is conducted[27]. Some industry players have pointed out that reporting is already extensive[28] and that what is lacking is not data but a better coordination among supervisors i.e. between domestic and EU regulators as well as between securities regulators and central banks, in order to improve the consolidation and use of the data that is already provided by asset managers.

26. Source Speech by R. Ophèle (AMF) at the CMVM annual conference – 8 October 2020.

27. This is permitted by the Management Company Passport aiming to optimize the functioning of management companies across the EU.

28. AIFMs provide liquidity reporting and UCITS also provide detailed statistical data on their positions facilitating liquidity analysis