ICMA
International Capital Market Association

Asset Management

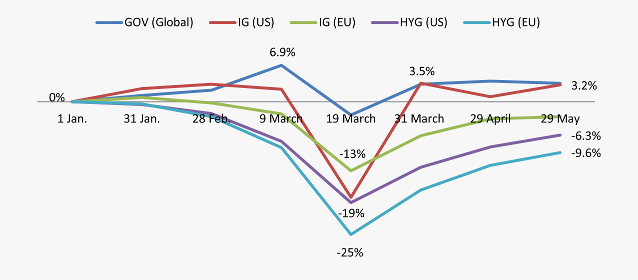
by Arthur Carabia

COVID-19: initial lessons for bond fund managers

Market update

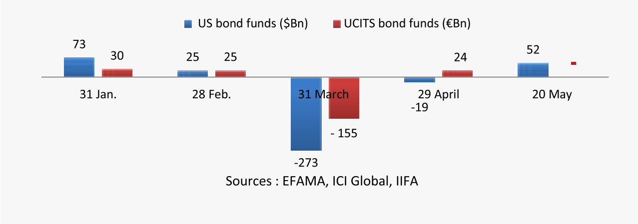
Euro bond funds were able to recoup at least partially their losses of the first quarter as flows stabilized and credit market rallied in the second quarter (see Figures 1 and 2), following the announcements of unprecedented policy measures to counter the economic impact of COVID-19 pandemic and with the gradual easing of lockdown measures.

Figure 1: YTD performance of index bond funds



Source : Bloomberg

Figure 2 : Bond fund flows



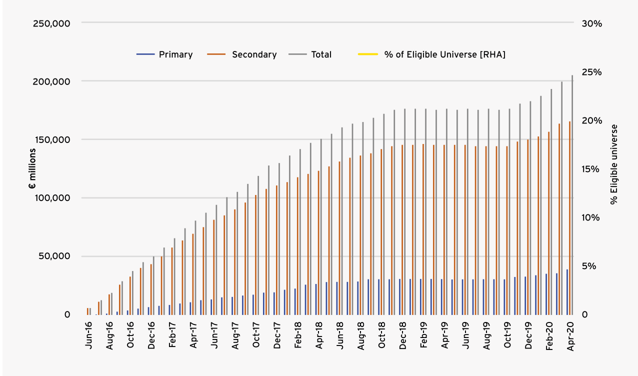
Source : EFAMA, ICI Global, IIFA

Potential risks ahead

Despite a much improved situation since the end of the first quarter, bond fund managers remain cautious, as the shape of the economic recovery remains uncertain and second waves of infections are not yet completely excluded. In that context, market illiquidity and fallen angels will remain important areas of vigilance:

Market liquidity: If volatility seems now under control, market liquidity, which was the main challenge during the peak of stress in first quarter, will remain a point of attention for fund managers as managers may still find it more difficult and costly than before the Crisis to find buy/sell positions and settle trades. Respondents to the ICMA study on *The European Investment Grade Corporate Bond Secondary Market and the COVID-19 Crisis* signalled only a partial recovery of liquidity, and one buy-side respondent shared their analysis suggesting that the generic bid-ask spread for European IG credit by the end of April was still at 21 basis points: twice the pre-crisis level. Asset purchases by central banks initially improved liquidity, but subsequently, as they buy and hold bonds to maturity, the bonds become scarcer, which could explain why the improvement in liquidity could remain capped in the medium-term.

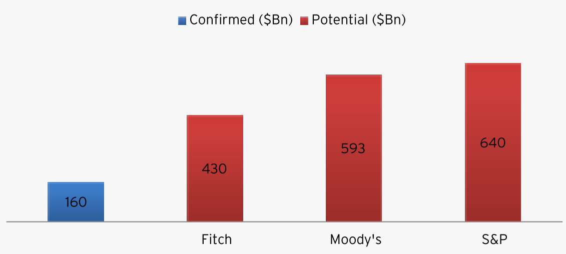
CSPP cumulative purchases



Source: ICMA analysis using ECB data

Fallen angels: Credit rating agencies have reacted promptly to the COVID-19 crisis, already downgrading $160 billion worth of bonds from investment grade to speculative grade during the first half of 2020. But this could only be the tip of the iceberg according to estimates (see Figure 3). If fallen angels usually present good opportunities for HY fund managers, they can potentially trigger forced sales and the realization of losses for funds or mandates, which are exclusively supposed to hold IG bonds. In reality, IG fund managers try to avoid this scenario, if it is in the best interest of investors and if they believe the bond in question is still in line with their strategy. Likewise, IG ETFs providers are not automatically forced sellers as fund prospectuses can allow them to hold a portion of out-of-index securities. Active and passive IG bond fund managers have therefore room for manoeuvre to handle fallen angels, provided that downgrades are done gradually and are not ballooning. ESMA, which supervises directly credit rating agencies, has already recommended the need to be mindful of the "timing between taking into account the increased risks of poorer credit quality and not acting pro-cyclically". Many other elements will need to be considered by credit rating agencies, including central bank measures and sectorial support programmes announced by governments, which may limit or smoothen the materialization of fallen angels by the end of the year. The Fed is buying junk bonds, so long as they were deemed investment grade on 22 March, offering a lifeline to riskier credit markets. Furthermore, the ECB is accepting corporate bonds that have been downgraded by ratings agencies to speculative grade since 7 April as collateral and is not required to sell its holdings in the event of a downgrade below the IG credit quality rating.

Figure 3: Fallen angels 2020



Policy observations

If central banks and government policy measures were instrumental in stabilizing markets, this crisis also highlights the resilience of European bond funds in a very difficult context:

- Despite the redemption shock (equivalent to 5-6% of total NAV of US and UCITS bond funds), the significant deterioration of market liquidity and operational constraints (home working), the vast majority of bond funds were able to meet redemption requests and operate.
- When available, the use of Liquidity Management Tools (LMT). such as swing pricing, temporary gates, anti-dilution levies, contributed to absorb the redemption shock and limited impact on asset prices by encouraging investors to stay in the fund.
- Steven Maijoor, Chair of the European Securities and Markets Authority (ESMA), suggested in early April on Reuters that, looking across all asset classes, less than 0.7% of AUM of EU domiciled investment funds were subject to either redemption halts or LMT.
- Looking specifically at bond funds, it was estimated that only 30 bond funds with €11 billion of AUM had temporarily to suspend dealings. The majority of suspensions were driven by issues in pricing of HY corporate bonds. It also mostly involved bond funds managed from Denmark, where funds have to price several times throughout the day, or from Sweden, where LMTs are not available.

In light of the above and following our January 2020 report on fund liquidity, AMIC continues to encourage policy makers to make LMT available at global and European level and to support the call emanating from other ICMA constituencies to reconsider the implementation of regulatory provisions which could be detrimental to market liquidity and bond fund liquidity such as the mandatory buy-in regime under CSDR.

We are pleased to see that: (1) the crisis has already contributed to accelerate the adoption of LMT tools in jurisdiction where they were not yet available (e.g. Germany); (2) some national supervisors have encouraged and facilitated the use of LMT, which proved again to be very helpful to tackle redemption shocks; and (3) that efficiency of these tools were once again recognised by the ESRB on 14 May: "management tools available to fund managers can help to mitigate first-mover advantage dynamics and the risk of asset fire sale".

Finally, AMIC welcomes the intensified dialogue between policy makers and asset managers since the beginning of the crisis. This allowed supervisors to monitor fund liquidity continuously, while flexing the deadlines of some reporting and prudential rules in order to prioritize business continuity and the orderly functioning of capital markets. Given that established dialogue and as much of the resource (frontline traders and risk managers, IT, operations, policy, legal, compliance and management) that would normally have been devoted to implementing legislation in the near term was fully deployed in fighting the crisis and not available, we would welcome further flexibility when it comes to upcoming implementation deadlines such as the Liquidity Stress Test guidelines due for September 2020.

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