Fund liquidity

Public policy debate after Woodford

Following the suspension of the Woodford Equity Income Fund, the Bank of England announced in its July 2019 Financial Stability Report a review, conducted jointly with the UK FCA, on redemption terms and liquidity management tools used by open-ended funds. Alex Brazier, Executive Director for Financial Stability at the Bank of England, confirmed the approach in a speech, delivered on 2 September: "As yet, this general solution [alignment between redemptions terms and underlying assets] hasn't been translated by the relevant regulators into specific global rules. So, in July, the Bank of England and the FCA announced that we will assess how funds' redemption terms might be better aligned with the liquidity of their assets. That will include assessing the effectiveness of liquidity tools that are already used and the cost and benefits of aligning the redemption terms with the typical time it takes to sell a fund's assets. (...) We'll report on our progress in our regular Financial Stability Reports."

While indicating in a letter to Lord Myners that it sees merit in having more stringent liquidity rules, the FCA also mentioned the difficulty of moving ahead unilaterally as most UCITS funds sold in the UK are established in the rest of the EU. It therefore remains unclear whether the Bank of England/FCA review could result in material and substantial changes for investment funds.

At international and EU level, securities regulators are being cautious regarding potential changes to the current framework. Following the Bank of England's July report stating that the international body had failed to the address the FSB's recommendation that funds' assets and investment strategies should be consistent with their redemption terms, IOSCO reacted: "[our] recommendations do, in fact, provide a comprehensive framework for regulators to deal with liquidity risks in investment funds, as explained below." At the same time, IOSCO confirmed its intention to "conduct a robust assessment exercise beginning in 2020 which will review how the 2018 *Liquidity Risk Management Recommendations* have been implemented in practice". In an interview given to the FT, Steven Maijoor, the Chair of ESMA stressed that: "We need to be careful about the suggestion that UCITS has to be changed [in response to the problems that have emerged at Woodford Investment Management]. It is important to emphasise that UCITS already establishes the principle that funds must be able to comply, at any time, with the obligation to redeem investors upon request."

ESMA's measures on micro- and macro-stress tests for investment funds

Alongside this policy debate, ESMA is continuing to further enhance and converge fund liquidity practices in the EU via three recent measures: (i) the guidelines on liquidity stress tests for money market funds (MMFs); (ii) the guidelines for investment funds' liquidity stress tests; and (iii) its first sector-wide stress test.

First, as required by the MMF Regulation, ESMA has issued, on 19 July, guidelines establishing common reference parameters for MMF stress test scenarios including: liquidity levels, credit and interest rate risk, redemptions levels, widening/narrowing of spreads among indexes to which interest rates of portfolio securities are tied and macro-economic shocks. The guidelines and calibration are expected to be updated at least every year considering the latest market developments.

Second, ESMA also released the final version of its guidelines on liquidity stress tests which apply fully to UCITS and leveraged close-ended AIFs, and partially to MMFs (paragraphs 16 to 24 and 74 to 81). The guidelines, which aim at converging liquidity stress tests' practices, feature provisions on the design of liquidity stress test models and scenarios, guidance for the stress tests on both the asset and liability sides, governance principles, frequency of the stress tests, reporting, and the use of the outcome.

While concerned about the short implementation deadline (30 September 2020), we were pleased to see that several recommendations formulated by AMIC were taken on board in the final version of the guidelines: (i) the principle-based approach is overall confirmed, allowing tailored liquidity stress tests; (ii) reverse stress tests and aggregated stress tests across funds are not mandatory but instead should be conducted when appropriate; and (iii) the required frequency remains on an annual basis, although more frequent stress tests are recommended when possible. AMIC will continue to ask regulators to provide more support to asset managers to overcome the challenge of data availability on the liability side, in order to improve the stress tests' models through better profiling of underlying investor types.

Third, following FSB 2017 recommendations, ESMA issued, on 5 September, the results of its first sector-wide stress test simulation for bond funds. ESMA has applied a redemption shock (weekly redemption ranging from 5-10% of NAV) to a sample of around 6,600 UCITS funds (€2.5 billion NAV) investing primarily in fixed income instruments ("since they are the more likely to face a liquidity mismatch than equity funds") and classified into five categories (High-Yield (HY), Emerging Market (EM) bond, euro fixed income, global fixed income and mixed funds).

The simulation concludes that: "overall most funds are able to cope with such extreme but plausible shocks, as they have enough liquid assets to meet investors' redemption

requests. However, pockets of vulnerabilities are identified, especially for HY bond funds. Under the severe but plausible assumptions of our simulations, up to 40% of HY bond funds could experience a liquidity shortfall (...)." Looking at the impact of asset liquidation on the market, ESMA states that "overall price impact is limited for most asset classes, as sales by funds are only a fraction of aggregate trading volumes. However, for asset classes with more limited liquidity, such as HY bonds and EM bonds, fund sales could have a material impact, ranging from 150 to 300 basis points, and generate material second round effects."

It is important to highlight that the results do not induce ESMA to recommend any policy/regulatory changes or definitive conclusion but are rather intended to inform asset managers and supervisors of the potential need for mitigating actions, including the use of liquidity management tools which are not taken into consideration for the purpose of the simulation. While ESMA points out that this report could be used by regulators to simulate stress situations for different segments of the fund industry, it also acknowledges in conclusion that the "modelling choices have had material impact on the results obtained". AMIC is therefore collecting views from members on the methodology used by ESMA and will consider if helpful improvements can be suggested.

Contact: Arthur Carabia
arthur.carabia@icmagroup.org