

Keynote Address

EU funds' resilience in the COVID era

EFAMA Investment Management Forum

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Chair

Ladies and Gentlemen,

I am delighted to have been invited again by EFAMA to give a keynote address at this important annual gathering. This year the event is taking place in a virtual format which is increasingly becoming our *new normal* given circumstances.

I will take this opportunity to share some thoughts on the events that occurred since my address to you last year. These events have far reaching consequences on our daily lives, but also a substantive impact on the financial sector and, more specifically, on asset managers and investment funds.

Last year, I focused my contribution on financial stability and investor protection, particularly on liquidity issues. This was inspired by events that occurred last year and pointed at liquidity risks in UCITS. As I already mentioned then, liquidity has been a key concern for a long time in asset management. Hence, there is nothing new on the topic as such, but the unprecedented events at the beginning of 2020 are of a magnitude which deserves some reflections on how funds reacted, especially in the context of the ongoing debate on the resilience of the non-banking sector in the EU.

Notwithstanding the fact that this year I will touch on similar issues to those that I discussed last year, in light of the recent events, there should be little risk of repeating myself (too much).

Today, nine months after the beginning of the COVID-19 outbreak impacting financial markets, I think it is time we take stock of its impact on investment funds. In my address, I will share

some of our findings on how investment funds have managed their liquidity in times of severe market stress. I will give my thoughts on the shortcomings the crisis has revealed and how managers, regulators and legislators could possibly address them in view of further increasing the resilience of the EU fund management sector.

Assessing the impact of the COVID crisis on EU funds

From mid-February the COVID-related events resulted in severe market stress, including for investment funds. This is an issue that we should take seriously in the EU because of the consequences for financial stability, and also for investor protection. I would like to emphasise the latter point. When funds face stress and liquidity issues, it is not only the financial system which may be affected because of the systemic relevance of the affected funds and their interconnectedness with the financial sector, but also individual investors may be heavily impacted. Their redemptions may be halted or limited or the proceeds substantially affected by the application of measures that are necessary to ensure the fair treatment of all investors (those redeeming and those remaining in the fund). Redemption fees, anti-dilution levies or swing pricing are typical examples of measures that may have to be introduced or adapted in extraordinary circumstances to ensure fair treatment of all a fund's investors. These measures may appear as a bitter remedy from an individual investor perspective, but they can be justified to ensure the fair treatment of the other investors and safeguard financial stability more broadly.

Mindful of the importance of these aspects, ESMA has reinforced its coordination role, and since last March we have organised frequent exchanges with national competent authorities (NCAs) to discuss market developments and supervisory risks linked to the COVID-19 crisis, focusing in particular on liquidity issues in asset management.

We fostered exchanges among NCAs on the use of liquidity management tools (LMTs) which play an important role in helping asset managers to deal with tense market situations. In addition, since end-March, ESMA collects data on the use of *extraordinary* LMTs such as suspensions of redemptions, redemptions in kind, side-pockets and activation of gates, but also the adaptation of LMTs which are commonly used (for instance, modification of the swing factor mechanism, increase in redemption fees or change in the dealing frequency of the fund).

Overall, there was an increased use of exceptional LMTs but still modest in absolute value. For instance, only 0.2% of asset under management within the EU were temporarily

suspended by the end of March 2020. Based on the information reported by NCAs, the great majority of suspensions were activated to protect investors' best interests in a context of valuation uncertainty. I will expand on valuation uncertainty later in my speech.

I believe that promoting prompt exchanges among NCAs at EU level on what is happening at national level in periods of market stress is crucial in a sector where cross-border activities are the norm. Indeed, what happens in one jurisdiction may well have consequences for investors in other jurisdictions and financial stability at EU level. Moreover, these exchanges are fully in line with the general ESMA mandate to coordinate NCAs, "in particular in situations where adverse developments could potentially jeopardise the orderly functioning and integrity of financial markets or the stability of the financial system in the Union"¹.

Yet, one could argue that fostering exchanges is not enough in situations with cross-border implications, in particular where these relate to financial stability. There are often situations where an investment fund is established in one Member State but its manager is based in another, and it might not be clear which NCA is responsible for supervising the suspension of redemptions and subscriptions, or the circumstances justifying an authority to intervene with suspension powers. This is the reason why more generally we recently expressed support for the idea that when there are cross-border financial stability implications, the respective NCAs roles should be specified in relation to their powers to mandate suspensions and there would be merit in granting ESMA a clearer coordination role in these cases².

Coming back to our COVID-related activities, the ESRB recommendation published last May deserves a special mention. This called for a supervisory exercise across the EU regarding investment funds that have significant exposures to corporate debt and real estate. The objective of this recommendation was to prompt supervisory work aimed at assessing the preparedness of these funds for potential future redemption and valuation shocks.

ESMA and NCAs, therefore, launched a data collection exercise during the summer with a focus on the crisis events between February and March of this year. This exercise – which we just concluded with the delivery of an ESMA report to the ESRB – was based on a common methodology developed at ESMA level, consisting of the analysis of the reaction of selected

¹ Art. 31 ESMA Regulation.

² ESMA letter to Executive Vice-President Valdis Dombrovskis on the Review of the Alternative Investment Fund Managers Directive dated 18 August 2020 (ESMA34-32-550).

investment funds to the recent events, and simulations of stress scenarios to assess their resilience in case of additional future stress events.

The ESMA report, which we will publish today, shows that overall, the investment funds under review managed to maintain adequately their activities when they faced redemption pressures and episodes of valuation uncertainty in the first quarter of 2020. Indeed, only 0.4% of these funds suspended their subscriptions and redemptions. However, an immediate and obvious finding is that this figure is twice as high as the one that I mentioned earlier (0.2%) for all funds at EU level. This difference can be explained by the fact that the analysed sample included only funds investing in less liquid assets or assets for which liquidity may recede in times of crisis.

In addition, these results need to be interpreted with caution for many reasons. First, the stress in the market was of short duration because of the swift action of central banks and governments. Secondly, some of these investment funds had potential deficiencies in their liquidity risk management or valuation processes under stressed market conditions. For example, the analysis identified funds offering a high redemption frequency without notice period or LMTs, while investing in illiquid assets or assets that may become illiquid during a period of market stress.

Two other takeaways are worth mentioning. First, concerns around the valuation of portfolio assets have emerged, especially for real estate funds for which the crisis could have a more significant impact over the longer term. Second, it was confirmed that the availability and use of LMTs vary considerably across the EU, depending on national rules and supervisory actions to foster their use.

Against this background, ESMA identified five priority areas to further enhance the preparedness of corporate debt and real estate funds to potential future redemptions and valuation shocks.

Three of them relate to key provisions that management companies should strictly observe. These provisions concern:

- (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.

In these areas ESMA urges asset managers to step up their efforts to ensure that the relevant requirements are adequately complied with. We also asked NCAs to pursue the ongoing monitoring of compliance with these rules. For instance, misalignments between the liquidity profile of funds' investments and their redemption policies should be corrected in a timely manner. The monitoring activities by NCAs should focus especially on those funds analysed in this exercise which should correct potential breaches of the requirements without delay.

Another priority area is the increase of the availability and use of LMTs, which should be taken forward in the context of the AIFMD review. As you will recall, both the ESRB and ESMA have recommended already earlier the adoption of harmonised rules regarding LMTs in the UCITS and AIFMD frameworks to ensure greater protection of investors and the consistent use of these tools. Pending this legislative harmonisation at EU level, some progress may already be achieved at national level on the availability and use of LMTs, in close coordination and cooperation with ESMA and NCAs.

The last priority area relates to the enhancement of the fund liquidity profile reporting under the AIFMD, to support a risk-based supervision of liquidity risks. Similar provisions should be introduced under the UCITS framework, where ESMA has also expressed support for the introduction of a reporting regime like the one under the AIFMD.

As you can see, this has been a very fruitful exercise that should lead to concrete follow-up steps, most immediately on the side of managers whose funds failed the relevant stress simulations and, more generally, those managers managing funds that showed deficiencies. This should be completed by appropriate supervisory action by the relevant NCAs across the EU. The ultimate objective is to enhance the preparedness of the fund industry, in a context where ESMA has raised the awareness about the fragile current market environment and the decoupling of financial market performance and underlying economic activity.

These priority areas also address, to some extent, the concerns expressed by the ESRB in relation to financial stability. ESMA considers that reducing the liquidity and valuation risks at the level of the investment funds sector would reduce the risk and the impact of collective selling by funds on the financial system, and therefore the likelihood of a systemic event.

What's next to ensure the resilience of the EU funds' sector?

I would now like to focus on specific deficiencies that materialised, during the COVID crisis, in the asset management sector and which deserve specific attention by regulators.

In March 2020, as volatility surged and investors rushed to raise cash, some segments of the EU MMF industry were subject to acute stress, while MMFs exposed to public debt (Public debt Constant Net Asset Value, CNAV) recorded large inflows as a result of the flight to safety.

Low Volatility Net Asset Value (LVNAV) MMFs and Variable NAV (VNAV) MMFs experienced challenges on both sides of their balance sheet. On the liability side, investor redemptions peaked in the second part of March, with outflows totalling 20% for LVNAV MMFs (EUR 120bn) and more than 10% for VNAV MMFs in some EU countries. On the asset side, money markets froze, with a large decline in issuance and a spike in yields, as banks and other participants were reluctant to buy commercial paper or certificate of deposits.

For LVNAV MMFs, this situation created the following challenges: to meet redemptions, managers had to sell assets. On the one hand, selling liquid assets would deplete their weekly liquid assets, and if the proportion of weekly liquid assets falls below 30% of their NAV, MMFs must consider implementing redemption fees or gates. On the other hand, MMFs could only sell other assets at discount prices, resulting in mark-to-market losses and deviation from their stable NAV, which in some cases reached 18bps, i.e. 2 basis points below the 20bps limit that requires conversion to VNAV.

Although requirements are different for VNAV MMFs (buffer of weekly liquid assets at 15%, floating NAV), such funds also experienced severe stress due to redemptions and lack of liquidity on the asset side, as VNAV MMFs and LVNAV MMFs tend to be exposed to the same asset classes.

Central bank interventions in the US and in the Euro area, through direct purchases of commercial paper or funding facilities, restored confidence end-March, with a reduction in outflows and an improvement in liquidity. Overall, no EU MMF had to use gates or fees to suspend redemptions. Nevertheless, these events call for further reflection on the remaining vulnerabilities in the MMF sector.

I would like to recall that, in the context of the Level 2 and Level 3 measures under the MMF Regulation, which have been adopted as a response to the 2008 crisis events faced by MMFs, ESMA has already developed in recent years a regulatory framework that will help in monitoring closely the risks related to MMFs in the EU at all times.

Managers of MMFs now need to develop common stress tests scenarios, which are standardised and specified by ESMA in the Guidelines on MMF stress tests, that we update every year to take into account market developments.

More importantly, as from this year, managers of MMFs need to report the results of these stress tests scenarios to their NCAs which in turn will have to report the results to ESMA. Going forward, the centralisation of the results of the stress tests will significantly improve the close monitoring of MMFs in the EU.

However, looking at March's events, the question to be asked is the following: is the current MMF Regulatory framework sufficiently robust to prevent future similar crisis episodes?

As I said earlier, the events of March 2020 have shown that despite regulatory reforms, vulnerabilities remain in the MMF sector. It is crucial to analyse in detail the reasons for these vulnerabilities in order to consider the potential policy reforms. Let me give you a brief overview of the issues to explore, noting that we are still at a very early stage.

First, there are still structural issues that need to be addressed. Indeed, the liquidity of money markets is quite low, even in normal times, which implies that during periods of stress, MMFs struggle to sell some of their holdings. Improving the liquidity of such markets could be an option to improve the resilience of MMFs.

Second, to be honest, I think further reforms of MMFs are needed. However, at this stage, there is no common view on which changes should be contemplated, and we need to assess the various policy options very carefully. The acute stress faced especially by LVNAV MMFs requires to further look into the role of NAV collars or the relationship between weekly liquid assets levels and fees and gates. For example, should further guidance on the use of liquidity buffers be explored? Should we reconsider the relationship between liquidity requirements and the use of fees and gates?

In that context, the upcoming review of the MMF Regulation can provide a timely opportunity to revisit the MMF framework, to make sure that MMFs continue to play their role as key intermediaries in the EU financial system, while improving at the same time their resilience.

Finally, and more generally, I reiterate my support to the development of a macroprudential framework for investment funds. The growth of the fund sector plays a positive role in the financial system, for example by supporting the debt issuance market and the financing of the

economy. But it also implies more interconnected EU capital markets. A macro-prudential framework is therefore a key element in making them stronger.

Most importantly, an extension of the macro-prudential framework to non-banking institutions will not need to be built from scratch. There are some existing foundations: in fact, important conceptual work is already underway for some time. At global level, the FSB and IOSCO will continue to provide financial-stability recommendations relevant to the non-banking sector, including market infrastructures, asset management and Securities Financing Transactions. ESMA is part to these discussions through our participation in the Standing Committee on Assessment of Vulnerabilities (SCAV) of the FSB and in the Financial Stability Engagement Group (FSEG) of IOSCO. These groups will build on the earlier work done by IOSCO in the area of Liquidity and Leverage for funds and will consider carefully the lessons learnt during the market turmoil this spring. These lessons will be discussed later this month at the G20 Summit.

At the EU level, the work of ESMA and the ESRB support that evolution. The recent ESRB recommendation on liquidity risks in funds, that I covered earlier, is one of the many initiatives carried out over the last few years. Another important one is the 2017 ESRB Recommendation on leverage and liquidity in investment funds. Actions taken in response to the latter include the publication of Guidelines on Liquidity stress testing in September 2019 and the ongoing work for the development of ESMA's Guidelines on leverage limits under the AIFMD. Therefore, ESMA expresses its full support for further initiatives to develop a macro-prudential toolkit for investment funds which could be taken forward by the ESRB in conjunction with ESMA and NCAs.

Conclusion

Ladies and Gentlemen let me now conclude with these remarks. It is not possible to predict how financial markets will develop in the months to come, but we can already draw some interesting conclusions from the past nine months.

First, the use of LMTs by management companies of open-ended funds, where available, was overall satisfactory and helped preserve the interest of investors, but there is still room for increasing the availability of these tools and supervisory convergence in the field of liquidity management.



Second, asset managers need to step up their efforts to ensure the liquidity of their funds is adequately managed and that they are prepared for future shocks. This is especially relevant for funds exposed to less liquid assets. This needs to be coupled with ongoing supervisory efforts to ensure compliance with the rules, and ultimately achieve financial stability and better investor protection. ESMA is ready to continue its efforts to coordinate NCAs activities in this area.

Third, we need to look forward to upcoming legislative reviews. In these, we must ensure that the lessons learnt from the COVID crisis are taken into consideration and that any identified weaknesses are addressed promptly in the best interests of the EU asset management industry, and the investors whose assets it manages.

Thank you for your attention.