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Ladies and Gentlemen,

I am delighted to have been invited by EFAMA to give this keynote address as it will allow me to share with you a few of my thoughts on asset management regulation and supervision and how this fits in the debate on financial stability and investor protection in the EU. I will focus my intervention on liquidity issues in particular as I think that they are key to this debate.

Improving the functioning of the internal market is at the core of ESMA's mandate, and asset managers – whether managing UCITS or alternative funds – are a key part of our work in particular when it comes to fostering supervisory convergence across the EU. The importance of asset management in and for the EU can hardly be overstated. The Union is home to more than 3,000 asset management companies with funds worth sixteen trillion euros of assets under management, making it the second largest fund market worldwide.

And this industry is thriving not least because the EU provides excellent operating conditions: a vast single market based on a regulatory framework which promotes competition and financial stability. Existing regulatory frameworks, including the UCITS Directive and AIFMD, have improved the functioning of markets, their transparency and ultimately the protection of investors.

UCITS is a particularly successful label, in Europe and beyond. UCITS funds are subject to substantial regulatory requirements, reflecting the fact that they should be liquid products that can be sold cross-border to retail clients on the basis of a passport. In the context of the CMU, one objective is to increase retail investor participation in financial markets. UCITS have a role to play in that context, as they should represent a label for investors who should be able to rely on a product which adequately ensures their protection. Of course, this does not mean that market risk can be eliminated and that investors are provided with a guarantee for their investments. However, to ensure the ongoing success of this product, high investor protection standards should consistently be applied across the EU. In this respect, ensuring that the liquidity of UCITS investments matches with the liability side of the product is of utmost importance to ensure investors' ongoing trust.

At the same time, we cannot afford to be complacent by relying on past achievements. As you are aware, two events affecting UCITS recently have drawn attention to liquidity risk. In one case, the manager decided to suspend redemptions following sustained outflows. In the other case, investors raised concerns over potential illiquid bonds exposures. Although both episodes did not turn into systemic events in the end, they have raised some concerns about UCITS and the label itself has been publicly questioned since then.

It is against this background that I decided that the key themes of my intervention should concern fund liquidity and how asset management can play its role in the Capital Markets Union while ensuring investor protection and financial stability.

First, I will focus on the issue of liquidity, which has been a key concern for a long time in the asset management sector. Secondly, I will talk you through ESMA's activities in relation to fund liquidity. In particular, I will highlight the main findings of our risk assessment and our strategy, both in terms of stress testing and supervisory action. Finally, I will briefly comment on the adequacy of the main requirements regarding liqiduity risk under the UCITS framework.

The elusive concept of liquidity

Let me first take a step back and look at liquidity from a more fundamental perspective. The concept of liquidity is an elusive one. It generally describes the degree to which an asset or security can be quickly bought or sold in the market without substantially losing value. When measuring it, there are a variety of possible metrics including market size, trading volume or transaction costs, as measured by the bid-ask spreads.

However, liquidity can change, and past liquidity is no guarantee for future liquidity. One dramatic historical example is given by asset-backed securities: at the onset of the global financial crisis, mortgage-backed securities were very liquid instruments both in terms of market depth and transaction costs, before suddenly drying up in July 2007. Although such events can be unpredictable, it is important to manage the uncertainty about liquidity properly. In my view, this underlines the importance of stress testing in liquidity risk management.

From an investor point of view, we fully understand that there may be good reasons to invest into more illiquid products. And from a policy standpoint, it is also desirable to have investors willing to make long-term investments, which can be less liquid. While UCITS are meant to invest in liquid assets, alternative funds such as, for instance, the European Long-Term Investment Fund (ELTIF) are, by design, meant to provide long-term financing for infrastructure projects or small and mid-sized companies. But where funds are investing in more illiquid assets, expectations of investors need to be calibrated to reality. Asset managers should ensure that the investment strategy and liquidity risk management are consistent with the redemption policy communicated to investors, in order not to raise unrealistic expectations.

Liquidity is a long-time concern in asset management

Liquidity risk is obviously not a new issue in asset management. From a regulatory perspective, both the UCITS Directive and AIFMD have various requirements in relation to liquidity management which are designed to mitigate this risk. UCITS especially can only invest in a range of assets that are deemed liquid, subject to limitations and rules which I will explore a little bit later in my remarks. With respect to the AIFMD, there are requirements on the fund manager to put in place liquidity management processes and stress tests, especially if they manage open-ended or leveraged funds.

From a financial stability standpoint, the issue has been highly debated at global level. In 2017, the FSB identified the potential mismatch in open-ended funds between the liquidity of fund investments and daily redemption of fund units as a key structural vulnerability, and tasked IOSCO to deliver recommendations, which were published in 2018. Similarly, at EU level the ESRB published a Recommendation on action to address systemic risks related to liquidity mismatches and the use of leverage in investment funds.

The challenge, of course is to find an approach to liquidity risks which adequately addresses the specific business of the asset management industry. Asset management differs significantly from banking and insurance activities. Firms manage assets on behalf of their clients, who agree to bear losses and gains. Banks and insurance companies, on the other hand, typically act as principals: accepting deposits with a liability of redemption at par and on demand, or assuming specified liabilities with respect to policy holders.

Therefore, redemptions in the fund sector do not entail the same consequences as a run in the banking sector. While asset managers protect the interest of their investors, as institutions they generally do not suffer from selling assets in difficult market conditions. In contrast, a bank selling assets to close the liquidity gap would record the potential value loss for itself. Moreover, undermined confidence in the institution would further depreciate its balance sheet and increase its financing cost.

Against the background, the primary reason why the asset management poses heightened financial stability concerns today is the growth of the fund sector by more than 60% since 2013. Moreover, there are concerns that the alleged search-for-yield behaviour, coupled with ample market liquidity, leads to mispriced risk and overvaluation of some asset classes. Eventually significant sales by asset managers could depress asset valuations, thereby transmitting stress to other institutions which may in turn be forced to sell assets. Cascading effects from fire sales can ultimately amplify deterioration of market confidence and deepen a crisis.

Challenges posed by the low-yield environment

We must acknowledge that the lasting low-yield environment has created unprecedented challenges for asset managers. Their business model allows for some flexibility as an asset management company can propose products ranging from equity to bond funds, and active to passive management. But it also creates incentives to take more risks, eventually exposing investors and other market participants. Especially, we observe shifts towards riskier and less liquid assets.

- Since 2013, EU investment funds increased their holdings of corporate bonds rated BBB from 31% to 35% and, for some of them, reduced their cash holdings. While liquid under current market conditions, BBB bonds are susceptible to become less liquid as risk perceptions and underlying credit conditions change.

- There is a rotation from equity to bond funds, and from equity ETFs to bond ETFs, the latter growing by 55% over the last 2 years. We also see evidence of funds, including ETFs, investing in less liquid markets such as commodity, gold or high yield. Eventually this may lead to unrealistic expectations of liquidity, if the perceived liquidity of these funds does not reflect the liquidity of their underlying.

The issue of fund liquidity is at the core of ESMA's activities

ESMA is particularly focussed on fund liquidity developments. The first priority is to further improve our understanding of risks. In that respect data collection such as AIFMD data plays a key role. Thanks to the joint efforts of the reporting asset managers, the NCAs, ESMA and the ESRB, the data is becoming more and more usable and ESMA published the first AIFMD statistical report in 2019 and we are currently working on the next release for early next year.

The 2019 report highlighted that real estate funds were the most exposed to liquidity risk. They have the largest liquidity mismatch among AIF types: within one week investors can redeem up to 20% of Net Asset Value (NAV) while real estate funds can only quickly liquidate 8% of their assets. Other categories of AIFs do not seem to have significant liquidity mismatches. Indeed, hedge funds may be exposed to financing risk, as one third of their financing is overnight, but they tend to maintain large cash buffers, which mitigate the risk. Private equity funds invest mainly in illiquid securities but funds are overwhelmingly closed-ended.

The AIFMD data allows us to also assess more specific issues. For example, in our recent trends, risks and vulnerabilities report we assessed the risks posed by CLOs as the exposure of European AIFMs increased by 15% during 2018 to reach EUR 109bn. Although risks appear to be limited at this stage, these exposures require active monitoring in a context of deterioration of underwriting standards and lower credit quality of the underlying.

The combination of different data sources will help understanding the channels through which liquidity risks can materialise. This is especially the case for EMIR data. For example, ESMA analysed the use of derivatives such as CDS by UCITS: it showed that the use of CDS was mainly concentrated in large funds following fixed-income or alternative strategies. A key liquidity concern for regulators pertain to the capability of such funds to meet margin calls, for example following a rapid change in the value of the derivatives they hold.

Stress testing

Going forward, liquidity risk is at the core of ESMA's stress test strategy, which encompasses three workstreams. First, the ESMA STRESI framework is a simulation-based approach whose general objective is to assess the resilience of the investment fund sector and its capacity to transmit or amplify shocks to the rest of the financial system. It is also a response to FSB Recommendation 9 which asks authorities to give consideration to system-wide stress testing that could potentially capture effects of collective selling by funds and other institutional investors on the resilience of financial markets and the financial system more generally.

As a first step, our recent report presents an application of the stress testing simulation framework to assess the resiliency of 6,000 UCITS bond funds to large redemption shocks. The results show that overall, most bond funds are able to cope with extreme but plausible shocks, as they have enough liquid assets to meet investors' redemption requests. However, pockets of vulnerabilities are identified, especially for High Yield (HY) bond funds. Under the assumptions of our simulations, up to 40% of HY bond funds could experience a liquidity shortfall, i.e. a situation in which their holdings of liquid assets alone would not suffice to cover the redemptions assumed in the shock scenario and recourse to less liquid assets would need to be taken.

As a second step, the impact of the funds' liquidation on financial markets has been modelled, as funds need to sell assets to meet investors' redemptions, thereby exerting downward pressure on assets prices. The results show that the 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 Emerging Markets (EM) bonds, fund sales could have a material impact, ranging from 150 to 300 basis points, and generate material second round effects.

Secondly, as part of its work on funds' stress testing, ESMA has recently published the Liquidity Stress Testing (LST) Guidelines in UCITS and AIFs, which promote convergence in the way the national competent authorities supervise funds liquidity stress. The Guidelines seek to ensure that asset managers across the EU undertake LST following a set of minimum standards, including the design and frequency of LST models, the governance principles for LST and how LST should be incorporated in the fund's risk management policies and procedure.

Finally on funds' stress testing, the framework was also further enhanced by the publication of the MMF Stress Testing Guidelines which have established common reference parameters of the stress test scenarios that MMFs managers are required to conduct. The Guidelines are updated yearly in order to take into account recent market developments, and, where appropriate, improvements to the methodology.

Supervisory action and liquidity requirements under UCITS

As I mentioned earlier, the two well known recent cases have drawn the attention of ESMA and the regulatory community. The UCITS framework includes a broad range of risk management provisions designed to ensure that all relevant risks, including liquidity risks, are identified, measured and effectively managed. This is why the recent events have led to a focus in ESMA on liquidity management in UCITS in order to assess whether there might be a mismatch between the redemption policies and liquidity profiles of some UCITS which may reveal non-compliance with the applicable UCITS rules.

For this reason, in order to foster convergence and promote consistent supervision with regard to liquidity risks, ESMA will facilitate a common supervisory action on liquidity management by UCITS. This is an exercise under which EU NCAs will agree to simultaneously conduct supervisory activity in 2020 on the basis of a common methodology to be developed together within ESMA. This initiative, and the related sharing of practices across NCAs, should represent a significant supervisory effort which is expected to help ensuring consistent application of EU rules on UCITS liquidity management and ultimately enhance the protection of investors across the EU. The nature of this coordinated exercise is very much in line with the spirit of the revised provisions of our founding Regulation that mandate us to put an even stronger focus on this type of exercise and more generally on supervisory convergence. Indeed, in the future ESMA will have to identify Union-wide priorities to be taken into account by NCAs when drawing up their work programmes at national level.

In the context of heigthened attention for UCITS fund liquidity risks, questions have been raised regarding the adequacy of the existing regulatory regime and whether additional rules are needed. It is important to stress that UCITS managers are already expressly required to employ an appropriate liquidity risk management process in order to ensure that each UCITS they manage is able to comply at any time with its obligation to redeem investors at their request. UCITS managers should further ensure that for each UCITS they manage the liquidity profile of the investments of the UCITS is appropriate to its redemption policy.

Moreover, the existing rules already address the concern that UCITS managers might invest in eligible assets whose liquidity profile would not be in line with their funds' redemption rules. A listing on an eligible market does not automatically mean that all specific securities of such market are actually liquid. While the Commission Level 2 Directive in 2007 ("Eligible Assets Directive") introduced a presumption of liquidity and negotiability in the case of transferable securities that are admitted or dealt in on a regulated market, it also clearly stipulates that this does not apply where information is available to the UCITS that would lead to a different determination.

Conclusion

Ladies and gentlemen, let me offer some concluding remarks on fund liquidity and on the role of the asset management industry and securities supervisors before opening up the floor for questions. Fund liquidity remains a crucial topic for ESMA and the securities markets supervisors. It is essential that investors can rely on their fund manager to have in place appropriate arrangements to manage both the liquidity of assets and redemptions in their funds. ESMA's work on stress testing and fostering a common supervisory action on liquidity management demonstrate our focus and commitment in this area.