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PRESS RELEASE

ESMA tells fund managers to improve readiness for future adverse shocks

The European Securities and Markets Authority (ESMA), the EU's securities markets regulator, has published a Report on the preparedness of investment funds with significant exposures to corporate debt and real estate assets, for potential future adverse liquidity and valuation shocks. The Report identifies five priority areas for action which would enhance the preparedness of these fund categories.

The priority areas identified to enhance the preparedness of the funds are ongoing supervision of the alignment of the funds' investment strategy, liquidity profile and redemption policy; ongoing supervision of liquidity risk assessment; fund liquidity profile reporting; increase of the availability and use of Liquidity Management Tools (LMTs); and supervision of valuation processes in a context of valuation uncertainty.

Steven Maijoor, Chair, said:

> "In the wake of COVID-19's initial impact on markets, the EU investment fund industry faced a significant deterioration in liquidity in some segments of the fixed income markets as well as valuation uncertainty in the real estate sector. This coincided with large-scale investment outflows from investors.
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> "ESMA coordinated a supervisory exercise with national securities regulators involving collecting and analysing data on funds exposed to corporate debt and funds exposed to real estate. The exercise showed that the funds in question managed to respond adequately to redemption pressures. However, the work also revealed shortcomings that must be addressed in order to enhance funds' preparedness to future shocks, and we have identified a number of priority areas that funds and supervisors should focus on to address potential liquidity risks in the fund sector. This will contribute to ensuring investor protection, orderly markets and financial stability.

> "We also encourage swift proposals to amend the EU legislative framework to ensure that liquidity management tools are widely available to asset managers across the EU."

The Report responds to the recommendation from the European Systemic Risk Board (ESRB) to ESMA, on 6 May 2020, to coordinate with National Competent Authorities (NCAs) a focused supervisory exercise on investment funds that have significant exposures to corporate debt and real estate assets.

Main results

The funds exposed to corporate debt and the real estate funds under review overall managed to adequately maintain their activities when facing redemption pressures and/or episodes of valuation uncertainty, and only a limited number suspended temporarily subscriptions and redemptions.

These results should be interpreted with caution since the redemption shock linked to the COVID-19 pandemic was concentrated over a short period of time, amid significant government and central bank interventions which provided support to the markets in which these funds invest. In addition, some funds presented potential liquidity mismatches due to their liquidity set up that should be addressed. This is especially the case for funds investing in asset classes illiquid by nature while offering a combination of high redemption frequency and short notice periods.

Concerns around the valuation of portfolio assets have clearly emerged, especially for real estate funds for which the crisis could have a more significant impact over the longer term. Moreover, real estate funds do not frequently adopt LMTs in their liquidity set-up.

Against this background, fund managers authorised under UCITS and AIFM Directives should enhance their preparedness to potential future adverse shocks that could lead to a deterioration in financial market liquidity and valuation uncertainty.

Five priority areas have been identified to enhance the preparedness of the funds and relate to the following topics:

1. Ongoing supervision of the alignment of the funds' investment strategy, liquidity profile and redemption policy;

2. Ongoing supervision of liquidity risk assessment;

3. Fund liquidity profile reporting;

4. Increase of the availability and use of LMTs; and

5. Supervision of valuation processes in a context of valuation uncertainty.

Next steps

In response to the COVID-19 crisis, ESMA has reinforced its coordination role regarding investment fund supervision through the organisation of frequent exchanges with NCAs on market developments and supervisory risks, in particular on liquidity issues. ESMA has also organised regular data collection on the use of LMTs by EEA UCITS and AIFs.

The actions related to the response to this ESRB recommendation are part of this supervisory convergence work, and ESMA will follow-up with NCAs in relation to priority areas 1, 2, and 5, in order to foster supervisory convergence amongst NCAs in the area of liquidity risk management and valuation in stressed market conditions.

From a financial stability perspective, the above priority areas should also reduce the risk and the impact of collective selling by funds on the financial system, by addressing the liquidity and valuation risks at the level of the investment fund. ESMA will continue to monitor this risk through regular assessments of the resilience of the fund sector and participation to the development and operationalisation of the macroprudential framework for non-banks.

Notes for editors

1. ESMA34-45-1119 Recommendation of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds

2. ESMA is the European Union's securities markets regulator. Its mission is to enhance investor protection and promote stable and orderly financial markets.

It achieves these objectives through four activities:

i. assessing risks to investors, markets and financial stability;

ii. completing a single rulebook for EU financial markets;

iii. promoting supervisory convergence; and

iv. directly supervising specific financial entities.

3. ESMA achieves its mission within the European System of Financial Supervision (ESFS) through active cooperation with the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Systemic Risk Board, and with national authorities with competencies in securities markets (NCAs).

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