JOANNA COUND

Managing Director, Global Public Policy,
BlackRock

A lesson from Covid-19: liquidity risk management is central to open-ended funds

March 2020 saw market liquidity deteriorate significantly – as many companies, banks, and investors looked to cut their risk and raise cash – and an extreme stress test of the previous decade's reforms. While UCITS and AIF outflows rose sharply to relative levels last seen during the Great Financial Crisis, they remained manageable, and the overwhelming majority of funds met all redemptions.

Strong fund liquidity management was instrumental in achieving this, and managers deployed tools ranging from swing pricing to suspending redemptions to protect their investors. Their availability was thanks to efforts post-2008 by IOSCO, ESMA, regional and national regulators to raise the bar for liquidity risk management. By 2020 best practises had been incorporated into many fund rulebooks, building on existing EU rules – for example in the UCITS Directive – to manage liquidity risk.

Funds suspensions were rare in March 2020, and mainly a response to idiosyncratic price uncertainty in regional real estate and bond markets: Fitch estimate that 0.11% of global fund assets were subject to suspensions during the turbulence; ESMA estimate 0.8% of EU-domiciled corporate bond UCITS were. Use of swing pricing – a mechanism for allocating a variable premium or discount to transactions in or out of funds – was more prevalent, and meant redeeming investors paid the higher cost of accessing liquidity. And while the primary purpose of swing pricing is to protect fund investors, from a systemic perspective it incentivised shareholders to remain invested; or spread redemptions over time.

To fully realise these benefits going forwards, use of swing pricing or similar 'anti-dilution' measures must be comprehensive. ESMA data on last year's turbulence shows swing pricing was used by many but not all EU funds. We strongly support extending implementation of the full liquidity risk management toolkit in all EU member states. This should also be accompanied by efforts to encourage the practical adoption of the tools by all fund managers.

An alternative suggestion – requiring funds to hold more 'High Quality Liquid Assets' – misunderstands fund liquidity. The notion that funds went into March 2020 with depleted 'liquidity buffers' incorrectly applies a bank regulation concept – HQLA – to asset management. Funds aim to meet redemptions while maintaining a risk-constant position over time, not by tapping cash buffers. In challenging market conditions, even high yield bonds could be sold to meet redemptions. Asset liquidity, and fund liquidity in turn, vary with market conditions and position size. Assumptions around both are continuously and rigorously tested by fund managers as a matter of course and in line with regulation (indeed in March 2020 EU fund managers were mid-way through implementing ESMA's new liquidity stress test standards for UCITS and AIFs).

Macroprudential policy measures would be at best ineffective, and at worst pro-cyclical. Open-ended funds only hold a portion of assets: McKinsey data shows asset managers accounted for 27% of global financial assets by end-2019, of which funds are only a sub-section. Attempts to manage system-wide conditions via macroprudential controls on funds would therefore be ineffective, missing most assets. And their effects may instead be counter-productive: some recommend mandatory cash or liquid asset buffers for funds, to be drawn down during stresses. Notwithstanding the performance drag, a buffer insufficient to meet redemptions will likely leave a portfolio more concentrated in risk assets to meet any subsequent outflows.

Achieving system-wide resilience should follow a three-pronged approach. First: make individual products and activities as robust as possible, for example by giving all funds the full liquidity management toolkit. Second: ensure banks can play their role as market intermediaries, setting prudential limits that strike a balance between safety and smooth market operations. Third: evolve market structure to reflect bank balance sheet constraints: many fixed income markets would benefit from modernisation – with more use of central clearing and electronic all-to-all trading venues – while securing quality, comprehensive, real-time data for all asset classes through a European consolidated tape would improve transparency and liquidity.