FRANCESCO MAZZAFERRO

Head of the European Systemic Risk Board Secretariat, European Systemic Risk Board (ESRB)

Liquidity mismatches in the NBFI sector should be addressed

The spread of the pandemic and the lockdown measures imposed to contain COVID-19 triggered an adverse shock to the global economy and large falls in asset prices. Markets reacted by substantially repricing risk, as investors fled towards safe and highly liquid assets. Assets in the non-bank sectors fell by EUR 1.2 trillion (3.3%) in the first quarter of 2020, mainly due to large valuation losses resulting from asset price falls.

Outflows rose and contributed to the fall in assets under management across a wide range of fund types. Redemption flows appeared to largely reflect the increased risk associated with the underlying assets and/or the demand for cash to meet short-term liquidity needs. Liquidity mismatches in certain types of open-ended investment funds amplified market volatility in late February and early March.[1]

The sudden rise in volatility led to a large increase in variation margin calls, putting additional pressure on some investment funds' liquidity positions. Derivatives data reported under the European Market Infrastructure Regulation (EMIR) show that daily variation margin calls on euro area investment funds rose fivefold, from around EUR 2 billion in the first half of February to over EUR 10 billion in the second half of March. For 27% of the funds for which EMIR data are available, daily variation margins exceeded their pre-pandemic cash buffers on at least one day during the period of market turmoil.[2]

A number of EU investment funds, particularly high-yield corporate bond funds and real estate funds, used liquidity management tools to help address outflows and valuation uncertainties. Some funds used quantity-based measures, such as suspensions of redemptions or redemption gates, while other funds used price-based tools, such as swing pricing or redemption fees, which impose the liquidity cost on the redeeming investors.

In response to these developments, the European Systemic Risk Board (ESRB) adopted a Recommendation to ESMA to coordinate a supervisory engagement with funds that have significant exposures to corporate debt and real estate assets.[3] In its response to the ESRB, ESMA noted that only a few funds have adjusted their liquidity set-up according to the pursued investment strategy and in light of liquidity strains they encountered.[4]

The vulnerabilities highlighted by the COVID-19 pandemic are not new and need to be addressed. In 2017, the ESRB issued a recommendation to ESMA and the European Commission on liquidity and leverage risks in investment funds.[5] The most important messages were: (i) the development of a common set of liquidity management tools for investment funds across EU jurisdictions, (ii) further setting out the role of ESMA when authorities use their power to suspend redemptions, (iii) measures to limit the extent to which the use of liquidity transformation in open-ended alternative investment funds could contribute to systemic risks, and (iv) enhancements of data reporting requirements for all type of funds.
Another market that came under stress during March 2020 amid substantial outflows from money market funds (MMFs) is the short-term debt funding market. In case of market stress, MMFs may be reliant on banks, corporates or central banks to purchase their commercial paper back in order to raise cash and accommodate heightened redemption flows. This materialised during March 2020. It is not the first time that MMFs contributed to the propagation and amplification of liquidity strains. In 2013, shortly after its creation, the ESRB had sent a recommendation to the European Commission on MMFs, requesting that Union legislation would require MMF to have a fluctuating net asset value and that stricter liquidity requirements be introduced. Despite the introduction of the Money Market Fund Regulation in 2017, which enhanced the regulatory regime for MMFs, vulnerabilities remain within MMFs and need to be addressed.

---

[1] See EU Non-bank Financial Intermediation Risk Monitor 2020, ESRB, Oct 2020
[2] See Liquidity risks arising from margin calls, ESRB, Jun 2020
[3] See Recommendation of the ESRB on liquidity risks in investment funds (ESRB/2020/4)
[4] See Report on the Recommendation of the ESRB on liquidity risk in investment funds, ESMA, Nov 2020
[5] See Recommendation of the ESRB on liquidity and leverage risks in investment funds (ESRB/2017/6)