ESRB
European Systemic Risk Board
European System of Financial Supervision

Use of liquidity management tools by investment funds with exposures to less liquid assets

The European Systemic Risk Board (ESRB) has been assessing potential financial vulnerabilities that could amplify the economic consequences of the coronavirus (COVID-19) pandemic.

In line with the work of other international organisations, this includes assessing issues relating to developments in market illiquidity and the potential implications for asset managers and insurers.[1]

The sharp fall in some asset prices at the onset of the COVID-19 pandemic was accompanied by large redemptions from some investment funds and a significant deterioration in liquidity in some markets.

Financial market conditions have improved more recently following decisive measures taken by central banks, supervisory authorities and governments across Europe and at a global level.

Previous ESRB assessments of non-bank financial intermediation have highlighted potential vulnerabilities stemming from investment funds that have short redemption periods but invest in less liquid assets.[2]

Such a mismatch between redemption profiles and the liquidity of assets held by some investment funds increases the risk that, in the event of large redemptions, they may have to sell less liquid assets quickly. This could contribute to further falls in asset valuations and add to strains on market liquidity.

Existing European rules include specific obligations on fund management companies to manage the liquidity risk of their funds appropriately. The rules also require that funds' investment strategies and the liquidity profile of their assets are consistent with their redemption policies.[3]

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[1] See, for example, the letter of 14 April 2020 from the Chair of the Financial Stability Board to G20 Finance Ministers and Central Bank Governors and *Global Financial Stability Report,* International Monetary Fund, 2020.

[2] See, for example, *EU Non-bank Financial Intermediation Risk Monitor*, ESRB, 2019, and Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6) (OJ C 151 30.4.2018, p.1).

[3] Article 40(4) of Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company (OJ L 176, 10.7.2010, p. 42): "Member States shall require management companies to ensure that for each UCITS they manage the liquidity profile of the investments of the UCITS is appropriate to the redemption policy laid down in the fund rules or the instruments of incorporation or the prospectus."

Article 16(2) of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 Text with EEA relevance (OJ L 174, 1.7.2011, p. 1): "AIFMs shall ensure that, for each AIF that they manage, the investment strategy, the liquidity profile and the redemption policy are consistent."

In line with its previous communications on investment funds, the ESRB emphasises the importance of the availability and timely use of liquidity management tools, especially in times of stressed market conditions.

In many European Union (EU) jurisdictions, asset managers have a wide range of liquidity management tools at their disposal. These include anti-dilution levies, redemption fees, swing pricing, redemption gates and the suspension of redemptions.

The tools are designed to ensure that investment funds with multiple investors can continue to operate in the best interests of all investors, both in normal times and in periods of stressed market conditions.[4] **The timely use of liquidity management tools is a key element of prudent liquidity risk management by investment funds.**

The use of liquidity management tools assist in addressing "first-mover advantage" dynamics, whereby redeeming investors may not bear the full cost of redeeming their shares, and part of that cost is instead passed on to the investors remaining in the fund.

In addition to protecting investors, the timely use of liquidity management tools (including those that help to ensure the appropriate allocation of redemption costs) also reduces the risk of forced sales of less liquid assets in periods of stress, helping to guard against the adverse system-wide effects stemming from fire sale dynamics across the financial system.

The ESRB notes that some asset managers have already made increasing use of such tools in light of the deterioration in market liquidity and rising redemption requests at the onset of the COVID-19 pandemic.

The ESRB believes that it is important for liquidity management tools to be used in a timely and appropriate manner, as is necessary in such circumstances, especially by funds with short redemption periods that invest in less liquid assets or assets that have become temporarily illiquid.

The ESRB notes that the availability of liquidity management tools has not yet been harmonised across the EU, raising challenges to the consistent application of such tools. To address this, the 2017 ESRB Recommendation[5] on leverage and liquidity in investment funds proposed making a diverse set of liquidity management tools available to fund managers to help them deal with redemption pressures when market liquidity is low.

The ESRB also notes that recent market developments highlight the need to make progress in implementing the 2017 ESRB Recommendation and to introduce adequate legal backing for the use of such instruments.

Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds (OJ L 169, 30.6.2017, p.8) sets out rules that are intended to make money market funds (MMFs) more resilient, limit contagion channels and ensure that MMFs are able to honour redemption requests from investors, especially during stressed market situations.

4 See, for example, the recommendations and good practices for liquidity risk management issued by the International Organization of Securities Commissions on 1 February 2018.

5 See ESRB/2017/6.