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Amundi ASSET MANAGEMENT

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Liquidity dilemma needs a regulatory response

INVESTMENT TALKS

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- ***Recent developments:*** *A few high-profile fund suspensions have recently driven the focus back to market liquidity and how this can affect the ability of funds to meet certain redemption scenarios. Despite ample liquidity at the macro level, some areas of strain remain at the micro level and could worsen in case of a material deterioration of economic conditions, a recession or a spike in volatility.*
- ***Vulnerable areas:*** *Some markets are highly vulnerable to a low-liquidity environment due to their dependence on foreign capital inflows and their concentration on trades, where the risk of an impact on market prices is high if asset sales have to be executed in a short period. In addition, some exceptional events such as Brexit could increase the pressure on market liquidity.*
- ***Opportunities for investors:*** *Investors could exploit opportunities in assets where indiscriminate sell-offs may result in price distortions that are not related to the solvency profile of the issuers, but rather to higher liquidity premia.*
- ***Regulatory action****: Financial regulators are enforcing liquidity requirements for asset managers in order to prevent a full-blown crisis. However, it is still early days and much remains to be done, as regulation of asset managers has been lagging behind that of banks since the global financial crisis (GFC).*
- ***Asset managers' action:*** *Asset managers could use different tools to monitor liquidity risks, on both a regular basis and in case of emergency. Such instruments include liquidity watch, monitoring swing prices, building liquidity buffers and managing a liquidity crisis situation. Under extreme circumstances, asset managers could even use their own balance sheet to prop up their own funds. However, this is a last-resort instrument, as it moves risks from investors to the asset manager. This is an option only for large asset managers, which enjoy continued connection with regulators, have global trading platforms and can be price makers.*
- ***Investors' action:*** *Investors could also take action against possible liquidity risks, including by increasing the share of high-quality and liquidity bonds in their portfolios, avoiding concentration in crowded or highly leveraged trades and assessing their fund managers' liquidity risk management processes.*

Why has liquidity climbed to the top of investors' concerns recently?

Liquidity has become a hot topic following a few high-profile fund suspensions. Those funds had invested in illiquid assets – including real estate and unrated bonds – in a search for yields but then faced difficulties in liquidating them to meet redemption requests. According to the July issue of the Bank of England's *financial stability report,* the mismatch between redemption terms and the liquidity of some funds' assets could become a systemic issue.

"Despite abundant macro liquidity, strains remain likely at the micro level, and could be exacerbated in case of an increased recession risk."

How do you reconcile abundant macro liquidity – thanks to the accomodative stance of major central banks – and areas of strain in some markets (micro liquidity)?

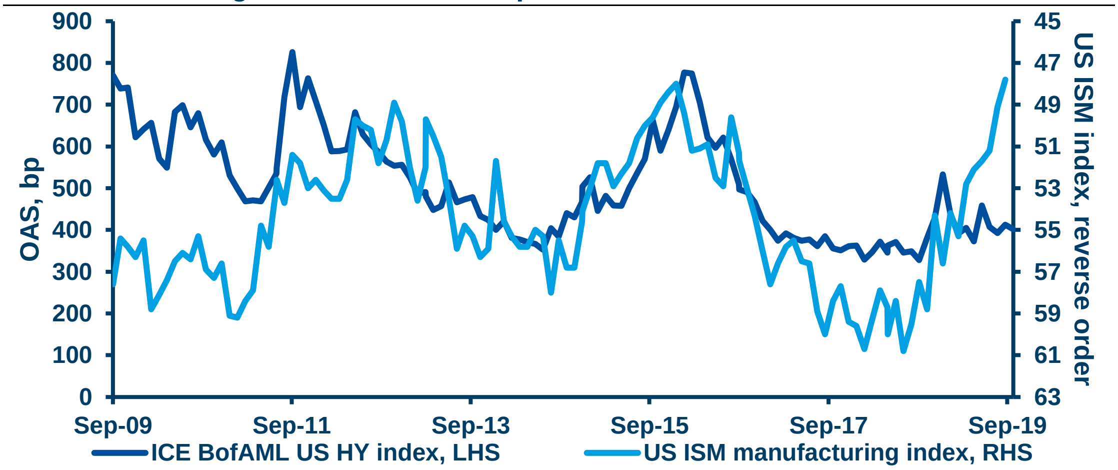
To understand this paradox it is important to differentiate between macro and micro liquidity, a topic we also covered in our *February paper* on liquidity. At the macro level, liquidity remains abundant and is not an issue given the accommodative stance by most G10 central banks. In the United States, the Federal Reserve *cut* rates in September for the second consecutive time and markets expect further cuts ahead. The ECB delivered a major easing *package* at Mario Draghi's penultimate meeting as the Bank's president, including restarting its asset-purchase programme. Despite such abundance, liquidity could still dry up at the micro level, as here it depends on the supply-demand dynamics.

What are the key factors that can affect market liquidity?

Supply and demand dynamics tend to be unbalanced (higher demand for selling risky assets) in periods of high volatility and when there is an escalation in geopolitical risks. Market liquidity is generally enhanced by the activity of market makers. These financial intermediaries enter buy/sell quotes to facilitate trading in financial instruments. They buy and sell for their own account (and as such this activity can be capital intensive) with the goal of taking advantage of the bid-ask spread differential. When the market environment becomes more uncertain or market movements become faster (such as when volatility spikes), this activity becomes riskier. As a result the bid-ask spread widens and/or the size available for buying/selling in the market decreases, increasing the cost of liquidating certain securities in the market.

Recent economic weakness at the global level, especially in the manufacturing sector, is an additional area of attention as it increases uncertainty on the asset class valuation, especially for the asset classes that tend to be more exposed to a weakening economic environment.

US manufacturing weakness and HY spreads



Source: Amundi, as of October 8, 2019. OAS = option adjusted spread; bp = basis point; a unit of measure equal to one one-hundredth of one percentage point (0.01%).

More generally, liquidity has diminished following the GFC since many banks have reduced their dealer/market maker activity due to tougher capital requirements. This could impair their ability to absorb liquidity demand in sell-off periods. While previously dealers could help set a floor on such moves, in the future, fewer actors with the ability to buy during stressed market phases – for example, the tactical hedge funds – are likely to remain and this will further worsen the imbalance between liquidity demand and supply.

Finally, despite the merits of keeping macro liquidity ample, the actions of central banks could distort the functioning of financial markets. As recent BIS *research* showed, as the share of assets held by central banks rises, there is an increased scarcity of bonds available for investors to purchase, squeezing liquidity in some markets. As yield curves flatten, credit spreads tighten and trading volumes shrink, some players may choose to leave the market, possibly exacerbating market malfunctioning when central bank balance sheets are unwound. This is what happened following the latest Fed rate hike in September, with a sharp rise in overnight borrowing costs forcing the Fed to inject USD 140 billion of liquidity.

"Vulnerable areas spotted by regulators are the United Kingdom (in case of a no-deal Brexit) and HY bonds."

In which areas do you see major liquidity risks?

Among the areas most likely to experience liquidity mismatches, some emerging markets are certainly key, as they rely heavily on foreign capital inflows. Those tensions could intensify as the cycle matures, the economic slowdown turns into recession and it becomes difficult to find buyers for illiquid assets. This is not our main scenario at the moment, but certainly an area of attention as fragilities have increased.

The United Kingdom is another area of vulnerability as far as liquidity management is concerned. With the Brexit deadline of October 31 approaching, the European Securities and Markets Authority (ESMA) and other financial supervisors have been preparing contingency plans to assure business and liquidity continuity in case of a no-deal exit.
Finally, high-yield (HY) bonds are also a vulnerable segment, as shown by a recent ESMA *analysis*, which found that up to 40% of European HY bond funds would not have enough liquidity to meet investors' withdrawals in case of a market shock. Furthermore, if they concentrate their asset sales, they will create downward pressure on prices, as daily trading volumes in the HY market are not as deep as a heavy-redemption scenario would require.

Can changes in liquidity conditions also offer opportunities for investors?

"Investors can exploit opportunities in assets where indiscriminate sell-offs may result in price distortions not related to the solvency profile of the issuers, but rather higher liquidity premia."

Periods of worsening investor sentiment and changing liquidity conditions can also offer opportunities. In particular, in phases of market uncertainty and a risk-off market mood, corporate bonds can experience higher liquidity premiums that could offer entry points for investors. This was the case, for instance, in the European investment grade primary market at the end of 2018 (and the beginning of January 2019), when new issue premiums peaked after the widening in the corporate bond spreads experienced during the market sell-off in Q4 2018. In the high-yield bond segments, discrimination is important to detect opportunities due to higher liquidity premia in the market. In fact, investors with the appropriate time horizon and available liquidity can benefit by selecting the issuers where a widening in the credit spread is a result of a short-term liquidity shrinkage rather than a worsening solvency profile. Similarly, some more liquid emerging market bonds can experience excessive repricing, as more liquid spaces could be used as "proxies" for scaling back the overall EM exposure in times of stress. Active investors can exploit these market distortions, which are not related to the credit profile of issuers.

How would you define liquidity from an asset manager's standpoint?

For asset managers, liquidity is their ability to meet redemptions with no major hit to the portfolio's value and structure and in the best interest of investors, that is, without impacting either the structure or valuation of the fund's assets. It depends on many factors, including macroeconomic scenarios, market conditions, the bid-ask spread and the fund's own liquidation strategy.

How could regulators prevent further liquidity scare episodes as we approach a late-cycle phase? Could new tools be adopted to monitor liquidity metrics?

"Regulators are setting common guidelines and procedures to protect investors on liquidity risks but we are still at the early stages of the process."

On September 30, the Financial Conduct Authority (FCA) – the UK watchdog – set out new liquidity rules for funds aimed at protecting investors in open-ended funds investing in hard-to-sell assets. From September 2020, funds falling into the new category of '*funds investing in inherently illiquid assets'* will be subject to deeper disclosure rules, enhanced depositary oversight and a requirement to produce liquidity risk contingency plans. In addition, the FCA will introduce a requirement forcing funds to halt trading if there is uncertainty about the value of assets worth at least 20% of their portfolios. This rule will initially apply only to property funds, but the FCA is considering extending this reform to the broader fund industry.
In addition, from September 2020 the new ESMA guidelines on liquidity stress testing for EU-domiciled UCITS and AIF funds will become effective. Such guidelines are designed to increase the standards and consistency of liquidity stress testing by asset managers, while promoting convergence in the monitoring procedures across EU countries.

How could asset managers be vigilant in assessing liquidity risks? Which procedures would you recommend on both a short- and long-term basis?

"Asset managers could address liquidity risks through multiple tools."

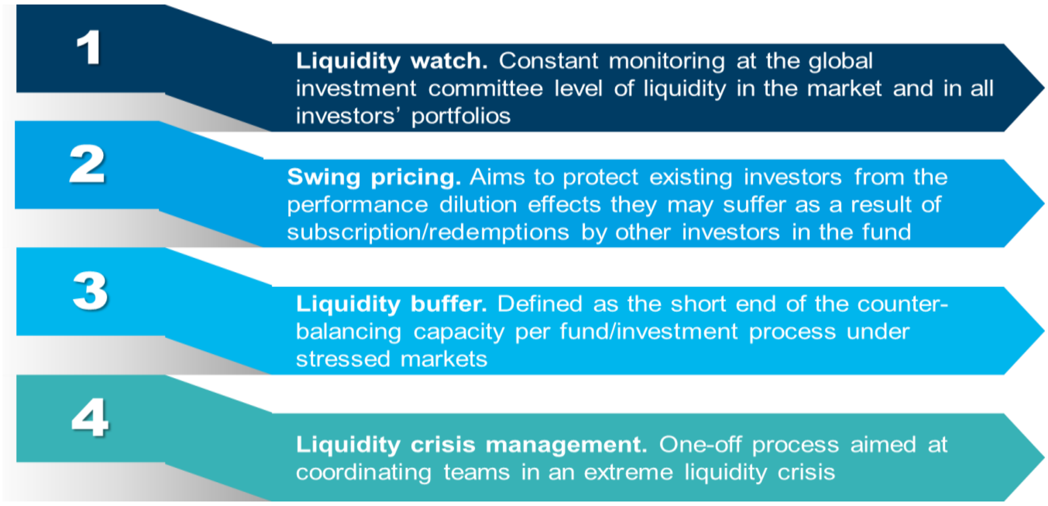
Asset managers have multiple tools to facilitate good liquidity management, to be applied either on a regular basis or in case of a liquidity crisis:

- **Liquidity watch**: liquidity management should be included in funds' investment processes, including at the group level. This refers to enhancing liquidity risk management and is based on an all-around set of factors, such as stress testing, scenario analysis, monitoring of market indicators and asset-class breakdown at both the fund and firm level. Ideally asset managers should do daily stress tests to be able to face redemption requests;

- **Swing prices**: this tool aims to protect existing investors from the performance dilution effect that the fund may suffer as a result of subscriptions/redemptions by other investors in the fund;
- **Liquidity buffer:** this aims at boosting each fund's counterbalancing capacity in distressed market conditions;
- **Liquidity crisis management**: this group of tools includes ad-hoc processes aimed at coordinating teams in an extreme liquidity crisis.

These steps would allow the identification of areas of possible liquidity risk, undertake any necessary action – if possible – and adjust the allocation to make it more resilient to a possible liquidity shock.

Multiple tools to deal with liquidity challenges



Source: Amundi, as of October 8, 2019.

In which cases could asset managers become a last-resort liquidity provider, possibly using their own balance sheet to prop up liquidity in their own funds?

"The way an asset manager could use its own cash to prop up its funds needs to be addressed by financial regulators."

This is an emergency weapon that large asset managers could use under extreme circumstances to boost their funds. In order to use their own balance sheet, asset managers need to be amply capitalised, which is not always the case. Following the GFC, financial regulators have tightened the capital requirements for banks, while asset managers have largely been unaffected by such regulatory overhauls. However, recently the FCA has required asset managers to increase their capital and implement a risk-mitigating programme. The UK financial watchdog currently has the toughest requirements for asset managers' capital, while in the Eurozone regulation is looser as it only requires asset managers to hold a capital buffer large enough to cover a six-month period of operating costs.
In the end, the available capital buffer comes down to single asset managers. If an asset manager deploys its own cash to finance investors' redemptions, the risk will be moved from clients to the manager itself and this is a last-resort tool to be used only under extreme circumstances. Large asset managers have advantages in this sense; being systemic actors, they enjoy a continued connection with regulators. They also have deeper liquidity sources thanks to global trading platforms, and can be price makers. Some clarification from financial regulators is probably needed on this topic and the debate on liquidity risk will remain at the forefront for investors, even more so in a more delicate economic environment.

What could investors do to hedge against liquidity risks?

Not only asset managers, but also investors could take action to protect against liquidity risks. Specifically, they could:

1. Include liquidity considerations in asset allocation and consider increasing the share of high-quality and liquid bonds as a liquidity cushion;
2. Avoid concentration in crowded trades and include liquidity considerations in the selection of investment ideas;
3. Avoid investments with excessive leverage that can be more exposed to liquidity risk; and
4. Assess fund managers' liquidity risk management processes.

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Definitions:

- **Asset purchase programme:** a type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Bid-ask spread:** it is the difference between the highest price that a buyer is willing to pay for an asset and the lowest price that a seller is willing to accept.
- **OAS: Option Adjusted Spread:** It is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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