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Recent EU Trends, Risks and Vulnerabilities Regulatory Reports

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September 25, 2020 TO: ICI Global Members
Global Advocacy Coordination Advisory Committee
Global Operations Advisory Committee
ICI Global EU Capital Markets Union Task Force
ICI Global Regulated Funds Committee
International Compliance Advisory Committee
International Internal Audit Advisory Committee SUBJECTS: International/Global RE: Recent EU Trends, Risks and Vulnerabilities Regulatory Reports

The European Supervisory Authorities (ESAs) have recently published updated risk assessment reports in which they identify trends, risks and vulnerabilities of relevance to regulated funds and their managers.

Joint Committee of the ESAs Risk Assessment Report

On 22 September 2020, the joint committee (JC) of the ESAs published[\[1\]](#) a report (“the ESA’s report”) on risk and vulnerabilities in the EU financial system.[\[2\]](#) In the ESA’s report, the JC asserts that the pandemic has led to further amplified profitability concerns across the board and heightened liquidity challenges in segments of the investment fund sector. The JC points particularly to economic and market uncertainty as key challenges going forward.

The JC considers that there is a significant risk of decoupling of financial market performance from the underlying economic activity and a prolonged lower for longer interest rate environment which is expected to weigh on the profitability and solvency of financial institutions, as well as contributing to the build-up of valuation risks.

The JC underscores the importance of regulatory and supervisory cooperation between the ESAs, the European Systemic Risk Board (ESRB) and the European Commission. In particular, the JC highlights the need to implement the following policy actions:

- **monitor risks and perform stress testing:** risks to valuation, liquidity, credit and solvency have increased across financial sectors. The use and adequacy of liquidity management tools in the investment fund sector should be continuously monitored;
- **foster flexibility where and when needed:** supervisors and banks are encouraged

to make use of the flexibility in the existing regulatory framework, including use of capital and liquidity buffers to absorb losses;

- **support to the real economy:** capital relief should be used in support of continued lending to the real economy in the downturn;
- **stay prepared:** EU financial institutions need to be well-prepared for any disruptions they and their clients may face at the end of the UK's transition period of leaving the EU;
- **supervise digital transformation:** it is key for financial institutions and their service providers to carefully manage their ICT and security risks, including when outsourcing ICT activities.

The JC also highlights risks they see in the investment fund sector^[3] including that:

the EU investment fund industry faced a significant deterioration of liquidity in some segments of the fixed income markets combined with substantial investment outflows from investors; and

some segments of the EU short-term Money Market Funds (MMF) industry faced liquidity challenges during the period of acute stress.

ESMA Trends, Risks and Vulnerabilities Report

On 2 September 2020, the European Securities and Markets Authority (ESMA) published^[4] its latest Trends, Risks and Vulnerabilities (TRV) report ("the TRV report")^[5] and supporting statistical annex.^[6] ESMA also held a webinar during which it presented the TRV report and its findings.^[7] In the TRV report, ESMA summarises its views of the risks to European financial markets, including the aspects outlined below which are of greatest relevance to regulated funds and their managers.

Market Monitoring

ESMA notes that the EU investment fund industry faced a significant deterioration in liquidity in some segments of the fixed income markets combined with large-scale investment outflows from investors. It highlights that redemptions from bond funds reached record highs in March, resulting in outflows of 4% of their net asset value (NAV) in 1Q20 and some asset managers decided to suspend the redemption of their funds, mainly because of valuation uncertainty but in some cases also because of outflows.

ESMA's empirical analysis suggests that between the second half of March and May around 200 EU and UK funds (out of 60,000 funds) had to suspend redemptions temporarily. Furthermore, ESMA notes that some corporate bond exchange traded funds (ETFs) traded with unusually large discounts compared with the reference basket, reflecting liquidity issues in underlying assets in March and April. ESMA finds that some money market funds (MMFs) were particularly affected end-March owing to their exposure to the USD money market, especially low volatility net asset value MMFs. Furthermore, ESMA highlights that since early April, the liquidity profile of funds has improved across fund types, with a surge in inflows and a general improvement in performance.

Risk Analysis

ESMA identifies the following three "risk" areas of relevance to regulated funds and their managers.

Interconnectedness and spillovers in the EU fund industry

ESMA highlights the risks of market-wide stress, not least for investment funds, resulting from the COVID-19 turmoil and assesses the connectedness among EU fixed-income funds.^[8] ESMA's empirical results suggest high spillover effects, indicating that funds exposed to less liquid asset classes are more likely to be affected by shocks originating in other markets than funds invested in more liquid assets. ESMA finds that alternative investment funds are found to be the main transmitters of shocks, while high-yield and corporate-bond funds were net shock receivers during the COVID-19 market stress.

MiFID II research unbundling: first evidence

ESMA analyses the impact on EU sell-side research of the MiFID II research unbundling provisions that require portfolio managers to pay for the research they obtain.^[9] ESMA notes the concerns have been raised in the past, based primarily on survey data, that the new rules could have detrimental effects on the availability and quality of company research in the EU. In order to provide a more detailed, data-based contribution to inform this discussion, ESMA examined a sample of 8,000 EU companies between 2006 and 2019 and did not find material evidence of harmful effects from these rules. As such, ESMA asserts that the introduction of MiFID II has not led to a significant difference in the number of analysts producing Earnings per Share (EPS) estimates ("research intensity"). Furthermore, recent increases in the number of firms no longer being covered by research analysts ("research coverage") appear to be a continuation of a long-term trend. ESMA considers that the quality of research has been steadily improving in recent years and SMEs do not appear to be particularly affected in terms of research intensity, research coverage, and research quality.

ESMA suggest that its descriptive findings are consistent with the emerging data-based academic literature on the impact of the MiFID II research unbundling provisions and are complemented by a forthcoming ESMA econometric study. ESMA sees merit in further assessment of the impact of the MiFID II research unbundling provisions on subsets of the EU market for research, such as the impact on sponsored research, could be interesting avenues for further study.

Costs and performance of closet index funds

ESMA defines "closet indexing" as a situation in which asset managers claim to manage their funds in an active manner while in fact tracking or staying close to a benchmark index.^[10] ESMA's analysis, including panel regressions using annual fund-level data for the period 2010 to 2018, suggest that investors face lower expected returns from closet indexers than from a genuinely actively managed fund portfolio. At the same time, ESMA finds that potential closet indexers are only marginally cheaper than genuinely active funds. ESMA's analysis suggests that overall, the net performance of potential closet indexers is worse than the net performance of genuinely active funds, as the marginally lower fees of potential closet indexers are outweighed by reduced performance.

ESMA has also published a working paper on closet indexing indicators and investor outcomes which sets out the analysis it referenced in the TRV report.^[11]

Next Steps

The trends, risks and vulnerabilities analysis undertaken periodically by the JC and ESMA feeds into broader risk and policy work undertaken by the ESAs.

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endnotes

- [1] Joint Committee Press Release: EU financial regulators assess risks to the financial sector after the outbreak of COVID 19 and call for enhanced cooperation, 22 September 2020, *available from*
<https://esas-joint-committee.europa.eu/Pages/News/EU-financial-regulators-assess-risks-to-the-financial-sector-after-the-outbreak-of-COVID-19-and-call-for-enhanced-cooperati.aspx>
- [2] Joint Committee Report on Risks and Vulnerabilities in the EU Financial System, September 2020, *available from*
<https://esas-joint-committee.europa.eu/Publications/2020-67-report-on-risks-and-vulnerabilities.pdf>
- [3] Section C, the ESA Report
- [4] Press Release: ESMA sees high risk of decoupling of financial market performance and underlying economic activity, 2 September 2020, *available from*
<https://www.esma.europa.eu/press-news/esma-news/esma-sees-high-risk-decoupling-financial-market-performance-and-underlying>
- [5] ESMA Report on Trends, Risks and Vulnerabilities No.2 2020, 2 September 2020, *available from*
https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1287_report_on_trends_risks_and_vulnerabilities_no.2_2020.pdf
- [6] TRV Statistical Annex, ESMA Report on Trends, Risks and Vulnerabilities No.2, 2020, *available from*
https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1274_trv_2-20_annex.pdf
- [7]
<https://www.esma.europa.eu/press-news/hearings/webinar-esmas-report-trends-risks-and-vulnerabilities-no2-2020>
- [8] Discussed in more detail on p74-81, TRV report
- [9] Discussed in more detail on p81-93, TRV report
- [10] Discussed in more detail on p93-101, TRV report
- [11] ESMA Working Paper No.2, 2020: Closet indexing indicators and investor outcomes, September 2020, *available from*
https://www.esma.europa.eu/sites/default/files/library/esmawp-2020-2_closet_indexing.pdf

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