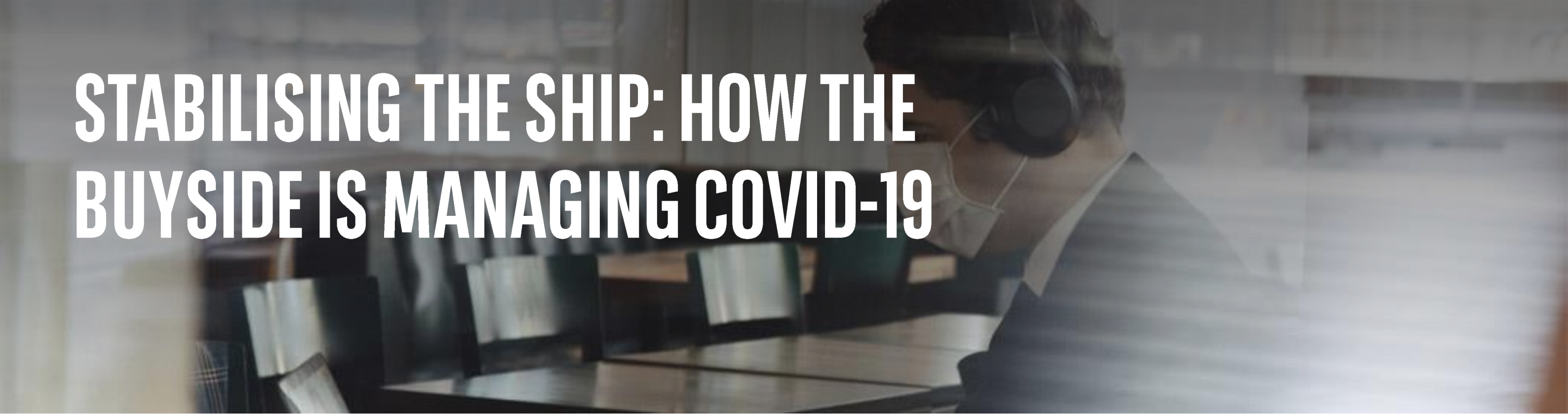

STABILISING THE SHIP: HOW THE BUYSIDE IS MANAGING COVID-19

BNP Paribas Securities Services shares its unique insights into some of the challenges asset managers and their asset owners faced during this unprecedented COVID-19 period.

The volatility and market swings witnessed in March 2020 – sparked by the precipitous spread of Covid-19 – surprised many investors. Although fixed income and equities have since staged a partial recovery, the market dynamics continue to be incredibly unpredictable and highly fragile. In this article, BNP Paribas Securities Services shares its unique insights into some of the challenges asset managers and their asset owners faced during this unprecedented period.

LIQUIDITY RISK MANAGEMENT GATHERS MOMEMTUM

Liquidity risk management took added precedence at managers, investors and regulators when a high-profile UK equity income fund gated client assets in mid-2019, but its significance has been cemented further by Covid-19. As the crisis unfolded, a mass sell-off of bonds, equities and commodities followed as investors de-risked portfolios and increased their liquid cash holdings. This sudden flight to cash prompted a slew of investors to deposit surplus capital at creditworthy global custodians such as BNP Paribas Securities Services.

Secure cash buffers are essential if daily dealing funds are to adequately meet their large-scale passive movements. Despite being confronted by the heightened fund transactional volumes and the challenges of staff working remotely, transfer agents have responded excellently and are processing fund orders without delay.

AVOIDING A LIQUIDITY BREAKDOWN

While asset managers have so far avoided a liquidity crunch, the industry cannot afford to be complacent about liquidity risk. If investor withdrawals accelerate even further, it could lead to another round of asset fire-sales at depressed valuations. In response, asset managers should introduce watertight liquidity risk management measures. Fortunately, investment firms do have a number of tools available to address this problem.

In order to safeguard the interests of the remaining investors in a fund, an asset manager may in some circumstances introduce swing pricing or an Anti-Dilution Levy (ADL). Swing pricing is a mechanism whereby the fund's NAV (net asset value) is adjusted to pass on to the purchasing or redeeming shareholders the costs associated with their passive movements.[1] Similarly, an ADL protects the remaining investors against the impact of large passive movements, as the transaction fees are borne by the redeemer or buyer.[2]

Although swing pricing is quite ubiquitous in the UK funds market, it is less a common occurrence among mainland European managers. Since the crisis started, BNP Paribas Securities Services has observed increasing numbers of continental European asset management clients implement swing pricing and ADLs. As a result, BNP Paribas Securities has fielded high volumes of urgent client requests to help them introduce short-term liquidity mechanisms to mitigate the risks of client outflows. Moreover, some managers may opt to introduce additional non-dealing days; reduce the frequency of permitted redemption days; or extend the settlement period and cut-off time. If managers are facing an acute crisis, they could be forced to adopt tougher countermeasures including gates; suspensions of redemptions or the introduction of side pockets.

While BNP Paribas Securities Services understands some managers have used swing pricing and ADLs, none have yet resorted to gating assets or introducing side pockets. The bank is confident that such requests are unlikely to materialise.

EFFICIENT COLLATERAL MANAGEMENT IS PIVOTAL

The market turbulence and volatility has created a spike in collateral management activities. The volume of margin calls has increased by 250% on average[3], prompting clients to find ways to optimise their collateral management. Elsewhere derivative use has spiked dramatically as investors hedge themselves against further potential market falls. In the context of their systemic importance, CCPs have ramped up their initial margining requirements and demanded members post intra-day collateral more regularly as they try and offset their counterparty risk exposures. The problem was compounded further as assets – due to be posted as collateral – saw massive price swings and steep devaluations.

1. IOSCO – Open ended fund liquidity and risk management – good practices and issues for consideration
2. EFAMA – Managing fund liquidity in Europe
3. BNP Paribas own analysis

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Those clients who have optimised their collateral management processes and built in robust solutions to mitigate operational risks have largely weathered the volatility. In addition, effective collateral management can enable for liquidity to be realised during periods of stress, especially if firms need to implement collateral substitutions. However, it is crucial that managers and investors engage with industry-leading collateral management providers if they are to adequately manage their operational risks and workloads. Moreover, it is essential that firms validate that their providers' operational set-up is sufficiently robust to absorb these extra volumes. By doing so, buyside firms are more likely to be fully collateralised which should help insulate them against any counterparty risk exposures.

GETTING ON TOP OF FX AND OUTSOURCING

Covid-19 has imparted on asset managers and asset owners the importance of having a clearly defined FX management policy. During the crisis, challenges faced by investors have included volatile assets; substantial portfolio re-balancings and sudden FX market gyrations, all of which have contributed to heightened FX exposure risk. More than ever, protecting portfolio performance has been about timing, accuracy and efficiency. It has been critical for the buyside to have rigorous FX measures and hedging strategies firmly in place.

Moving forward, BNP Paribas Securities Services believes more buyside institutions will delegate their FX management to experienced service providers who can support them with a full range of solutions covering FX risk hedging, execution and settlement. Not only does this streamline FX execution for asset managers and asset owners, but it can dramatically reduce their settlement risks, allowing firms to simplify their back office processes, thereby making major cost savings. By outsourcing their FX needs, asset managers and owners can reduce their operational burden and focus on their core investment activities. Further, outsourced providers are also more cost efficient as they typically adopt a variable charging structure as opposed to fixed rates.

The crisis could also result in more firms outsourcing some or all of their trading desk operations. They recognise the efficiency benefits that can be accrued through optimised dealing costs; a variable charging structure, better liquidity; easier access to new markets, asset classes, and the robust IT infrastructure at leading service providers. In addition, outsourced trading desks – given their size relative to asset managers – are in a stronger position to handle large volumes of transactions in stressed conditions.

COVID-19 LEADS TO REGULATORY DELAYS

As asset managers and asset owners attempt to counteract the existential challenges posed by Covid-19, market regulators have acted swiftly and delayed a number of incoming requirements. The European Securities and Markets Authority (ESMA) announced in late March that reporting obligations for MMFs under the Money Market Funds Regulation (MMFR) would be deferred from April 2020 until September 2020 in what should give managers additional time to comply.[4] Similarly, ESMA has urged local regulators to be flexible if UCITS and AIFMs cannot provide their annual or half-yearly reports on time.[5]

The importance of fund oversight has also been amplified by the ongoing crisis. UCITS and AIFMD both require asset managers to appoint fund depositaries to monitor their operational activities. As the severity of Covid-19 intensified, the UK's Financial Conduct Authority (FCA) instructed depositaries such as BNP Paribas Securities Services to provide them with more information about the financial health of their clients. Under the emergency rules, depositaries must alert the FCA if a fund manager suspends trading; incurs a 10% slump in performance on a single day; is unable to meet margin calls or is suffering from a high number of trade fails.6 Countries other than the UK, have taken similar measures, not least France, Luxembourg and Belgium.

Elsewhere, a number of high-profile regulations have been pushed back too. For instance, ESMA has since announced that the Securities Financing Transaction Regulation (SFTR) will now come into force three months later than planned in July 2020. It is possible the Shareholder Rights Directive II (SRD II) could be delayed amid industry calls for a reprieve. In early April, the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions confirmed there would now be a one year postponement of the September 2020 and September 2021 phase-ins of the initial margining requirements for non-centrally cleared derivatives, citing the operational capacity issues facing many firms.[7] This agreement has been formally approved at the EU level.[8]

SECURITIES LENDING AND REPO MARKETS WEATHER THE STORM

Buyside demand for access to the repo market saw an exponential increase during March's volatility as institutions sought to obtain financing to manage their liquidity risk , meet margin calls on derivative positions and in some cases satisfy redemption requests.[9] Analysis by the International Capital Markets Association found the repo market's capacity was tested initially as banks were forced to ramp up direct lending to corporate clients amid the dry up in demand for commercial paper.[10] However, the intervention of Central Banks did free up banks' credit lines allowing for cash to be deployed in the repo market. Despite the crisis situation, BNP Paribas Securities Services has successfully adapted and is fully supporting its clients' repo needs.

Similar short-term disruption was observed in the securities lending market with a sharp increase in requests to cover fails and recalls. However, the situation has since stabilised, possibly as a result of the short-selling bans. Short-selling bans are a common phenomenon during crises, and a number of EU regulators (Austria, Belgium, France, Greece, Spain) have since implemented them in response to Covid-19. Short-selling bans, however, have faced heavy criticism from hedge funds and stock exchanges, who argue that such restrictive measures often cause more harm than good by undermining market liquidity and price discovery.

Although ESMA has not introduced a blanket EU-wide ban on short-selling, it has instructed all holders of net shorts in EU traded shares to notify regulators if their positions exceed 0.1% of issued share capital.[11] This threshold was previously set at 0.2% and a number of European regulators including the UK's FCA have indicated they will apply these provisions.

STRONG COUNTERPARTIES ARE A NEED TO HAVE

Service providers with balance sheet strength, creditworthiness, operational robustness and industry-leading technology and expertise will be essential in ensuring that asset manager and asset owner clients are shielded from the worst excesses of Covid-19.

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4. ESMA – ESMA announces update to reporting under the Money Market Funds Regulation
5. ESMA – Actions to mitigate the impact of Covid-19 on the deadlines for the publication of periodic reports by fund managers
6. Financial Times – UK regulator demands early warning on funds at risk of suspension
7. FCA – BCBS and IOSCO announce a one year deferral of the remaining global initial margin requirements in response to coronavirus challenges
8. https://eba.europa.eu/joint-rts-amendments-bilateral-margin-requirements-under-emir-response-covid-19-outbreak
9. ICMA – The European repo market and the Covid-19 crisis
10. ICMA - The European repo market and the Covid-19 crisis
11. Shearman – Short sale bans in response to the Covid-19 pandemic

NOTES

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