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CONSULTATION AFG'S RESPONSE

Corporate bond markets – drivers of liquidity during COVID-19 induced market stresses

AFG

The AFG federates the asset management industry for 60 years, serving investors and the economy. It is the collective voice of its members, the asset management companies, whether they are entrepreneurs or subsidiaries of banking or insurance groups, French or foreigners. In France, the asset management industry comprises 700 management companies, with €4800 billion under management and 85,000 jobs, including 26,000 jobs in management companies.

The AFG commits to the growth of the asset management industry, brings out solutions that benefit all players in its ecosystem and makes the industry shine and develop in France, Europe and beyond, in the interests of all. The AFG is fully invested to the future.

CORPORATE BOND MARKETS – DRIVERS OF LIQUIDITY DURING COVID-19 INDUCED MARKET STRESSES

Introduction

The COVID induced market stresses in March 2020 highlighted some reduced liquidity in the corporate bond market. This is a result of a temporary mismatch of supply and demand of liquidity driven by many market participants during this crisis. A large part of corporate bonds is held through open-ended mutual funds or ETFs, but not the only ones.

AFG represents the French asset management industry, and we believe that the role of the open-ended funds (OEFs) should correctly be assessed in light of their design, their operating rules and their own specific regulation. Our answers will naturally be focused on that topic.

We would like to start by reminding that the OEFs are investment vehicles designed with a specific investment universe, with a clearly disclosed investment strategy and objectives. For instance, ETFs have very limited leeway regarding their component's selections and weighting rules.

It is tempting to consider that creating or increasing cash buffers in OEFS asset can help to mitigate liquidity risks. However, the more cash funds keep, the less they are able to respect the fund investment strategy (as usually a fund is not dedicated to be invested in cash).

It should be recalled that cash is not a goal as such, except for margining, monitored on an ongoing basis. Sterilizing investment portfolios with cash buffers is not desirable. In case of anticipated redemptions, the cash buffer might increase, but AFG members aim to avoiding unnecessary distorting of the fund profile.

This leads to the following conclusion: it is important to acknowledge that OEFs portfolio asset liquidity level is a direct and immediate reflection of the market current liquidity conditions.

This does not mean that liquidity risk cannot be managed. AFG would like to highlight that our members evolve in a jurisdiction that already applies the IOSCO's Recommendations. AFG members implemented in addition the ESMA's Guidelines on liquidity stress-tests in application since September 2020, which enhanced the regulatory requirements tackling that topic and provides a satisfactory level of control. In addition, the risk management includes also the use of liquidity management tools depending on the different degrees of market deterioration.

Simply put, OEFs liquidity are a directly connected with the market liquidity level in which they are invested and can hardly be considered as accelerator of a liquidity crisis.

Discussions questions

1. What are your views on the key outcomes drawn from IOSCO's analysis of the corporate bond markets? Are there any aspects of the diagnostic analysis and the key outcomes with which you disagree or that would benefit from more nuance? Are there additional regional or jurisdictional specific considerations? Please be specific to each observation and indicate why.

As a general comment, we consider it is dangerous to set a policy based on a single event such as the March 2020 market turmoil: regulatory policy changes must be based on more comprehensive market situations, as otherwise they might be inappropriate in the other market situations.

Moreover, in our view the IOSCO's report does not differentiate enough between the US and EU market situations, while we saw:

- that the turmoil was far stronger in the US as compared to the EU (in particular as in the EU the Quantitative Easing (QE) policy was still positively ensuring more market liquidity than in the US where QE had been officially stopped in 2014);

- that the behaviours of central banks were different between the US and the EU. For instance, US fund managers benefited from a last resort intervention from the US Federal Reserve, while the EU fund managers are not allowed to benefit from such an access to the central bank money.

Another remark is that we have the impression that **IOSCO is not enough taking into account the underlying real economy situation in its reasoning: in our view – and by contrast with the 2008 financial crisis – the March 2020 market turmoil event was not generated by the financial sphere itself, but the consequence of both health and economic crisis. In 2020, there were several clear steps:**

- a health crisis leading to almost worldwide lockdown political decision;
- that health political decision of lockdown led to global economic freezing;
- the financial markets adapted to that global economic freezing;
- governments through budget and fiscal policies, as well as central banks through monetary policies, injected respectively public expenses and money in the system to avoid both economic and financial crashes.

Last, even if IOSCO is aware of it, a critical aspect is to ensure a better coordination :

- between securities regulators and central banks (acknowledging the specificities of each sector);
- at domestic and cross-border levels.

2. Does the report capture and accurately describe the main features of the corporate bond markets? Is there a particular aspect (or aspects) that may be missing?

As mentioned above, we consider that IOSCO is not differentiating enough:

- the market events and situations from one region to another (e.g. US vs. EU market situation);
- the central banks' behaviors, in time and in tools, from one region to another (e.g. US vs. EU central banks' behaviors).

And therefore, it would be very dangerous to set a general regulatory policy rule at IOSCO's level if such differentiated situations are not taken into account – notwithstanding the fact that the March 2020 turmoil was a single event and should not necessarily lead to general conclusions, which might not be appropriate in any other situation.

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6. Does the report accurately describe the state of liquidity in corporate bond markets during the COVID-19 induced market stress across the three stated measures employed in the report?

It is important to make distinctions between different jurisdictions. In fact, during the Covid period there was still a Quantitative Easing program in Europe while it was not the case in the US. The credit spread was therefore narrower in Europe.

In the US the spread began to normalize, after a sudden increase in March 2020, following the Fed's announcement of a series of programs focused on financial markets. But, in Europe there was still a QE effect.

These elements support the fact that the corporate bond market in Europe was not in distress to the same extent as the markets in the US.

7. Do you agree with the overarching analysis of the drivers of buyside investor behavior set out in this section?

Regarding OEFs, the crisis did not last until to generate additional liquidity difficulties and portfolios remained sufficiently liquid during the crisis and needed no additional arrangements.

We understand that the swing pricing mechanism was the most liquidity management tool used among our members and was triggered when substantial redemptions occurred.

Usually, swing pricing is implemented on asset classes deemed a priori less liquid (credit, HY, small cap, convertibles)

They are activated when redemptions are above the set thresholds.

8. Are the main demand side drivers of liquidity by investor-category accurately described and reflective of events in your experience of the COVID-19 induced market stresses?

The main concern for long-term investors (such as insurance companies) was not, as such, the liquidity one but rather the credit default concern.

Regarding the role of open-ended funds, clients redeemed as they needed cash to meet different liabilities due to the pandemic. The type of intermediation was therefore not the issue as the clients needed cash in any case: similar investors which needed cash, and accessing either directly to financial markets or indirectly through investment funds, behaved in the same single manner. It means that the open-ended funds were not any accelerator of the financial market tensions.

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