

ESMA publishes stress simulation framework for investment funds

Steven Maijoor, ESMA Chair, said:

“The stress simulation framework is a key element of ESMA’s stress testing strategy, which also includes guidelines on liquidity stress testing and on money market fund stress testing. The resilience of the fund sector is of growing importance as it accounts for an increasing part of the EU financial system.

“This framework will be an important tool for supervisors to assess risks in the asset management industry, as the methodology developed by ESMA can be applied across the industry’s different sectors.”

The development of the fund industry has provided retail and institutional investors with a range of investment vehicles, and in the period between 2007 and 2018 the total net assets managed by EU-domiciled UCITS funds have increased significantly from EUR 6.2tn to EUR 9.3tn. Therefore, it is crucial to ensure that the fund industry is resilient and is able to absorb economic shocks.

ESMA, in applying the stress simulation framework to the UCITS bond funds sector, has simulated a pure redemption shock, where a large number of investors request to reduce or withdraw their parts in the fund within a short timeframe. The results show that overall, most funds are able to cope with such extreme but plausible shocks, as they have enough liquid assets to meet investors’ redemption requests. However, pockets of vulnerabilities are identified, especially for High Yield (HY) bond funds. Under the severe but plausible assumptions of our simulations, up to 40% of HY bond funds could experience a liquidity shortfall, i.e. a situation in which their holdings of liquid assets alone would not suffice to cover the redemptions assumed in the shock scenario and recourse to less liquid assets would need to be taken.

As a second step, the impact of the funds’ liquidation on financial markets has been modelled, as funds need to sell assets to meet investors’ redemptions, thereby exerting downward pressure on assets prices. The results show that the overall price impact is limited for most asset classes, as sales by funds are only a fraction of aggregate trading volumes. However, for asset classes with more limited liquidity, such as HY bonds and Emerging Markets (EM) bonds, fund sales could have a material impact, ranging from 150 to 300 basis points, and generate material second round effects.

Next steps

The method described in this report can be used by regulators to simulate stress situations for different segments of the fund industry. ESMA has also discussed the underlying data in detail with the relevant national authorities, to ensure the knowledge gained from this case study can benefit

the day to day supervision of this sector.

ESMA will use this stress simulation framework as part of its regular risk monitoring to identify risk and assess possible adverse scenarios that might impact the EU fund industry.