irish funds

Webinar for DPs for Fund Risk – advice on Covid19 related issues

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This was the third in a series of webinars being held by Irish Funds providing updates and a forum to exchange information within the DP peer group.

Below is a summary of the areas covered:

1. Governance

Outline the importance of having a good governance framework in assisting the DP for Fund Risk during periods of stress?

- Good governance structures are essential in stressed times to ensure compliance with regulations, provision of value to stakeholders and maintenance of client interests.
- The ability to be able to make critical decisions over a short timeframe is essential to ensure liquidity is managed effectively. It is important all governance arrangements surrounding these processes are fully understood by all stakeholders.
- In order to ensure a firm can react swiftly and effectively to market/liquidity stress, they should ensure that from the outset they understand what liquidity management tools (LMTs) are available, how these tools operate and what the decision making process is to ensure correct steps are taken. The communication process, as well as roles and responsibilities, internally and externally needs to be clear e.g. advising the depositary.
- It is important to ensure all stakeholders fully understand the governance arrangements and decision making processes, and that regular communication and updates from the individual DP right through to the relevant Committee's and Boards is taking place to ensure everyone is fully abreast and informed of the issues at hand right now.

Outline some of the difficulties that are facing DPs in the current operating environment?

- DPs are currently having to operate in a very challenging environment, not least because the crisis has a very personal aspect to it and people are under increasing strain and having to work remotely.
- Increased overlapping communication and information requests from the regulator (UCITS liquidity questionnaire, LMTs questionnaire and daily/weekly reporting on, for example BCPs, valuations and liquidity), delegates and the board are adding additional complexity.
- It is important that DPs have open communication to their delegates to ensure they are getting timely and accurate information that they will need to pass onto boards and the regulator (e.g. liquidity and valuation issues) to ensure they are aware of any potential issues.
- The DP should also ensure that they are aware of any redemptions due and of any LMTs that may need to be invoked to manage this.

Many firms are having regular engagement with the Central Bank of Ireland ("CBI") during this period, have you any experiences you could share?

- Early engagement with the CBI is critical. This should be done with a clear plan as to how you are intending to manage the issue.
- Feedback from those who have engaged with the CBI has been very positive but again engaging early is critical, noting that some issues in particular can be flagged ahead of time.

2. Stress Testing

Funds have been under stress levels not experienced since 2008. How has this impacted fund stress test modelling?

- This current period has ensured that the robustness of stress models have been tested. Firms need to consider that on an ex-post basis did the stress tests accurately reflect what actually happened. This should be something all firms should be looking at.
- Additionally, the '08 crash might have been seen previously as an anomaly, but now this is not the case and funds need to consider if their risk profile is still appropriate.
- The data that we have seen over the last month should not be underestimated in terms of importance. This is valuable data that should be collected and used to update fund models.
- This data can also help in terms of modelling investor attitude and behaviour during a stressed period.

Credit risk has been a big talking point during the last few weeks, maybe you could share what you are seeing from a credit risk and credit stress testing perspective?

- A downturn in the credit cycle was expected at some point in 2020 though the current crisis has both accelerated and exasperated this. For example, spreads on US investment grade CDSs are 2.5 times what they were at the beginning of the year and US corporate bond spreads the widest since July 2009.
- This shows credit markets have been deeply impacted, though the intervention measures taken by the FED and ECB have helped.
- Scenario analysis is difficult as there is no historical data or similar crisis to build on, so credit managers are having to build in scenario generation capabilities which is very challenging. As such it can be expected that there will be a large diversity of potential loss/default estimates.

3. General Considerations

Can you please give examples of other areas firms should also focus on?

VaR Overshooting (VaR funds) –

- A UCITS is permitted 4 overshoots during the year. Any breach of this needs to be communicated to the Board and CBI, providing information and any documentation on the circumstances of the overshoot and confirmation the VaR model is still appropriate or measures taken if its accuracy needed to be updated.

Synthetic Risk and Reward Indicator (SRRI) –

- The SRRI groups funds into buckets of risk depending on their level of volatility. As such the extreme levels of market volatility seen recently may have an impact on this figure, and funds may have to update their KIID documentation in the coming months as a result, especially those that had been close to the border levels of their bucket.

- Additionally any increases in the SRRI should be communicated to your distribution network, as this may impact the investors they are selling to, and additional disclosures or risk narratives in KIIDs may need to be included (e.g. liquidity or fund specific). Cost and production challenges should also be planned for.

Leverage and Redemptions (Commitment approach funds) -

- Funds with higher leverage should consider the implications of a large redemption which could cause a breach in the global exposure limit. Consideration may need to be given to reducing some derivative positions and the cost on remaining investors this would have. Monthly rolling FX hedges should also be considered to ensure any market deviation with volatility is being fully captured in the calculations.

4. Liquidity

Please discuss liquidity generally both in terms of assets/liabilities and also regulatory interactions?

Assets -

- Large volatility has impacted valuations but so far, we haven't experienced funds not being able to liquidate assets. Actions taken by the FED and ECB have helped markets, but we should be not complacent.

Liabilities -

- While there have been investor flows out of funds such as money market funds, we have found institutional investors so far to be quite sticky and haven't seen really large redemptions from our funds. We have seen funds using swing pricing/ADLs but to date not having to resort to gating or suspensions. DPs also have to be aware and cognisant of the varied factors that can impact redemptions, including government intervention e.g. Australia's action on pension fund withdrawals.

Regulatory Interactions -

- The CBI message is quite clear, the bank wants to be made aware of major redemptions and what, if any, liquidity management tools a fund might be considering. It is very important to be proactive in this regard. The Bank is open to discussion and notifying them as early as possible is key.

Please discuss liquidity management tools and the role they are currently playing or could end up playing for funds?

- Ensuring fair treatment of investors is key and it is important to balance the interests of the current investors with those investors exiting the fund.
- Boards need to consider the implementation of any LMTs carefully (e.g. swing pricing, ADL or gating). For example, if a fund has an SRRI of 2 it is expected to be liquid but if it is not as liquid as expected an ADL may need to be introduced. This could impact remaining investors who may not want to remain in a fund with an ADL in place.
- LMTs are there to manage liquidity, once the liquidity has been managed it has been seen that boards will remove.