Enhancing Liquidity in European High Yield Funds

Executive Summary

- Several recent episodes in the European investment industry have exposed the vulnerabilities of offering daily liquidity to holders of open-ended funds investing in illiquid asset classes.
- The ensuing discussion as to whether or not the promise of daily redemptions is appropriate for vehicles holding illiquid investments has not spared high yield bond funds.
- While the European Leveraged Finance Association (ELFA) acknowledges the importance of this topic for high yield bond fund managers, it is the organisation's view that there is much more that can be done to enhance liquidity conditions in the European high yield debt market before ceding the argument that sub-investment grade bonds should be considered in the same context of other less liquid asset classes.

Runs on Open-Ended Funds Expose Problems of Illiquid Asset Holdings

During the past 18 months, a number of headlines have re-exposed the problem of open-ended funds owning illiquid assets while offering daily liquidity to their investors. Such funding mismatches forced funds' advisors to choose either the Scylla of honouring redemptions by selling assets at rock-bottom prices or the Charybdis of suspending fund redemptions to investors demanding the return of their capital. The latter course of action is often the only viable option for a fiduciary attempting to preserve value for both departing and remaining fund investors, but it is usually an experience that none wishes to repeat.

High yield mutual funds and their equivalents historically have operated under the premise that the sub-investment grade securities they hold are liquid enough for the provision of daily liquidity to their fund investors. However, all but the most recent cadre of market participants have known periods in which liquidity has been severely tested. For this reason, high yield bonds' suitability for daily dealing funds has been thrown into the fund liquidity debate alongside asset classes, such as real estate, that are widely acknowledged to be illiquid.

The European Leveraged Finance Association thinks that the question of liquidity mismatches in open-ended funds is an important one across asset classes. However, it does not accept the premise that high yield bonds are de facto illiquid in nature and therefore subject to the recent scrutiny that has been applied to other asset classes. It is ELFA's view that there is more that could and should be done to create the pre-conditions for market liquidity in European high yield bonds before accepting the view that high yield funds should impose tighter limits on fund redemptions. (In fact, several recent European fund suspensions have demonstrated that regulations intended to enhance liquidity have been followed in the letter but not in the spirit of the rules to the detriment of open-ended fund investors.) We see a tightening of existing UCITS regulations, more transparency through better financial disclosure and other measures as the path to achieving this.

The Inadequacy of UCITS Definitions of Liquid Securities

As in any market, there are certain pre-requisites for ensuring that European high yield bonds are sufficiently liquid. These include but are not limited to market depth (i.e. the number of buy-side and sell-side participants and the diversity of opinions), access to information (i.e. the ability of investors to independently make an informed opinion of an asset's value from available information), counterparty credit risk (the ability of the buyer/seller to deliver the cash/asset to the seller/buyer). The manner in which securities markers are regulated can play an important part in ensuring that the minimum criteria for maximising liquidity are met.

Open-ended investment products in Europe are most commonly established under the EU's UCITS (Undertakings for Collective Investment in Transferable Securities) framework. Without going into the minutiae of the rules that govern UCITS products, suffice it to say that diversification and liquidity are their guiding principles. The former is largely addressed by various exposure thresholds, such as the 5/10/40 rule.[1] UCITS seeks to achieve the latter by generally limiting a regulated fund's permitted investments to transferable securities and money market instruments that are either listed on a stock exchange or traded on a regulated market. Only 10% of the fund's net assets can be allocated to instruments that do not meet these criteria, i.e. the "illiquid bucket". (N. B. Subject to various constraints UCITS funds can also hold cash deposits, certain derivatives and shares in other collective investment products that are excluded from the 10% illiquid bucket.)

Despite the stipulation that the majority of a UCITS-regulated fund must consist of transferable securities or money market funds, neither one of these pre-conditions ensures instrument-level liquidity. One of the primary reasons for this is that the bar for designating a financial instrument an eligible security under UCITS is fairly low. For the most part, it merely requires a listing on an EU or non-EU stock exchange. This requirement does little to enhance a high yield bond's liquidity as it is not typically an exchange-traded instrument to begin with.

While it is true that stock exchanges mandate their own public listing conditions, these can be minimal, e.g. requiring just two years or less of audited financial statements, or permitting the listed issuer to provide limited investor reporting, management information, etc. With exchanges competing for issuers' business, it is difficult to see how this competitive dynamic does anything but work against investors' interests for greater transparency and disclosure – two essential pre-conditions for market liquidity.[2] While obtaining an official exchange listing might go a long way towards making a financial instrument eligible for open-ended UCITS funds, it simply does not follow that doing so renders the instrument liquid.

It would be logical to presume that for a money market instrument to be UCITS eligible, it should be widely quoted at narrow bid/offer spread and/ or it can be redeemed with cash after a short holding period. However, under UCITS, the criteria for money market instruments' eligibility are more nuanced. Their inclusion in UCITS-regulated funds is dependent on the instruments in question not only being deemed liquid (i.e. readily convertible into cash within 7 days), but also "being normally dealt in on the money market" and having "a value which can be accurately determined at any time".[3]

While the first two criteria are straightforward, the third criteria concerning value determination is surprisingly subjective. This is because there is no requirement to obtain a market price, so long as the instrument's value is determined by valuation

[1] The 5/10/40 rule is a UCITS diversification requirement that restricts a fund's holding to no more than 10% of securities of a single issuer. Furthermore the total amount of exposure to issuers that represent 5% or more of the fund's holdings cannot not exceed 40% of the fund.

[2] By way of comparison, all US SEC registered issuers must meet clear and specific disclosure requirements, such as the familiar and freely available 10K, 10Q and 8K filings.

[3] To meet the first part of this definition, i.e. deemed liquid, an instrument need only satisfy one of four criteria including either one of the following two: a maturity of up to and including 397 days; and a regular yield adjustment occurring at least every 397 days.

systems that are in turn based on either market data or on valuation models. Such leeway could allow a fund manager to hold relatively high yielding off-index instruments with a reliably unwavering mark thereby enhancing the risk/reward optics of a portfolio. However, if redemptions require the manager to sell the asset, there is no guarantee that there will be a bid to match the valuation at which it is marked. The alternative of waiting for up to 397 days for the issuer to redeem the asset is thin solace for investors desiring their money back now.

European leveraged credit market participants are doubtless attuned to the contradiction of a regime that generally restrict European funds' ability to hold leveraged loans even though they are often far more liquid than instruments that qualify for the "liquid" portion of a UCITS regulated fund. As recent UCITS regulated fund suspensions have demonstrated, compliance with UCITS rules is not sufficient to ensure a fund's liquidity, which in turn depends on the liquidity of the underlying assets. ELFA therefore believes that European regulators should do more to close loopholes that allow illiquid assets to pose as liquid securities, while at the same time doing more to ensure that the pre-conditions for liquidity in "on-the-run" public securities, such as rated high yields bonds, are strengthened and re-enforced.

Recommendations for Improving High Yield Bond Liquidity

ELFA believes that there are a number of areas upon which market participants should focus their efforts if it wishes to enhance the functioning of open-ended European high yield bond funds.

For one, there should be a baseline level of listing requirements that serves the interests of better liquidity. ELFA therefore suggests the creation of a "Qualified Exchange" listing which would mandate a set of minimum standards. Only high yield bonds listed under this protocol would be eligible for UCITS funds. Qualified Exchange listing rules should include and not be limited to the following criteria: minimum size of issue; minimum number of holders post re-offering; at least three years of audited financial history; mandatory minimum earnings financial disclosure requirements; minimum level of disclosure for insider transactions, prompt releases of earnings following the end of a reporting period, etc. However, not all efforts to bolster security-level liquidity can come through enhanced listing requirements.

ELFA believes that one of the key underpinnings of a liquid high yield market is transparency through disclosure. When only a limited number of market participants are sufficiently informed of an issuer's business activity, its financial health or even its existence, liquidity is bound to be constrained. For this reason, ELFA continues to speak out against selective financial disclosure via password protected websites or by emails to a limited number of registered investors. While the Qualified Exchange concept could be one way to address this issue, ELFA believes that it should be a fundamental principle of public securities markets and that all such disclosure should be readily available to investors and non-investors alike.

Another pre-condition for liquidity is market depth, which in turn is derived from the quantity of informed buyers and sellers willing to make a price for a given security's risk. Market depth not only requires the widespread availability of transparent financial disclosure, it is also a function of the breadth of a security's ownership base. Broad ownership is in turn a function of several factors including the size of the security, its index eligibility, and the concentration level of a given asset's investor base.

If financial market regulators wish to improve daily dealing high yield bond funds' ability to meet investor redemption requests, it can do so by mandating minimum high yield bond issue sizes for "liquid bucket" eligibility in UCITS funds and requiring such securities to have public credit ratings from recognised rating agencies. Both measures would serve to maximise the chances for index eligibility, which should further promote security level liquidity.

Minimum dealing sizes can also impact a security's liquidity. US HY market bond issues typically have minimum dealing pieces of $2,000 of face value with $1,000 additional increments. In the overwhelming majority of European high yield bonds, the purchase size has to be at least €100,000 and in many instances, the increment is €100,000. This means that smaller funds wishing to own €50,000 of notional exposure can own either €100,000 or nothing, which in turn makes it more difficult for small European high yield bond mandates to achieve diversification (i.e. a €1m portfolio can own no more than 20 bonds in European high yield bonds whereas a $1m portfolio in the US could own up to 50 individual bonds).

While seeking to enhance conditions for more liquid high yield markets in Europe, ELFA does not wish to abolish the ability of high yield bond funds to hold illiquid securities. As recent European fund suspensions have shown, it has been the bending of UCITS rules for holdings in the 90% liquid component rather than the 10% of allowable illiquid securities that has caused problems for managers facing redemptions. ELFA believes that it is of particular importance for high yield bond funds to have an explicit allowance for "illiquid" instruments, such as non-transferable securities and loans within the 10% bucket. This is for the simple reason that maximising recovery for investors in defaulted high yield bonds often entails receiving a portion of unlisted non-transferable instruments as a result of the debt restructuring. High yield funds' inability to participate in such instruments transfers an inordinate amount of upside to investment vehicles that can hold such assets, it also results in an inflated cost of new capital for post-default borrowers.

Conclusion

Over-reliance on a rules-based approach to UCITS fund eligibility has done little to promote and enhance the conditions for a liquid high yield market. Obeying the letter of the rules rather than the spirit has led to a host of recent scandals which in turn has led people to question the suitability of certain investments for open-ended daily dealing funds in Europe. Before any consideration of high yield bond funds as a category requiring more restrictive redemption provisions, regulators and market participants should focus their attention on the numerous measures that could facilitate more liquid trading in the underlying asset - high yield bonds. ELFA supports a re-examination of UCITS rules to ensure that exchange-listed transferable securities and money market instruments are truly liquid while allowing and refining the definition of the 10% illiquid bucket to the benefit of high yield fund investors. At the same time ELFA continues to advocate more transparent and thorough public financial and covenant disclosure in the firm belief that this will create a more liquid high yield bond market.

About the European Leveraged Finance Association

The European Leveraged Finance Association (ELFA) is a professional trade association comprised of European leveraged finance investors from over 30 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA website: www.elfainvestors.com.

Our Mission Statement:

ELFA seeks to create a more transparent, efficient, and resilient leveraged finance market while acting as the voice of its investor community. To that end, our diverse forum of investors engages with other industry professionals in order to educate and to promote best practices and transparency.