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AFG RESPONSE TO CONSULTATION PAPER

Response to the FSB consultation report on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds.

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 €4600 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.

RESPONSE TO THE FSB CONSULTATION REPORT ON LIQUIDITY MISMATCH IN OPEN-ENDED FUNDS

Structural liquidity mismatch (Recommendation 3)

Q1: Should "normal" and "stressed" market conditions be further described to facilitate the application of the bucketing approach? If yes, how would you propose describing such conditions?

Q2: Are the examples of the factors that should be considered in determining whether assets are liquid, less liquid or illiquid appropriate? Are there other factors which should be considered and, if yes, which ones and why?

Q3: Is the use of specific thresholds an appropriate way to implement the bucketing approach? If yes, are the proposed thresholds for defining funds that invest mainly (i.e. more than 50%) in liquid or less liquid assets and funds that allocate a significant proportion (i.e. 30% or more) of their assets to illiquid assets appropriate? If not, which thresholds would be more appropriate and why?

AFG response

It is largely acknowledged **that liquidity can change over time, and past liquidity is no guarantee for future liquidity**. Liquidity is a dynamic and relative notion. [It is particularly true in Europe where the size and deepness of the security markets are smaller than the in US market].

Accordingly, the bucketing approach proposed by FSB with fixed thresholds cannot properly fit in an efficient manner the liquidity assessment of the funds' assets. Moreover, it **could trigger unwanted cliff effects and procyclical behaviors which could possibly worsen the liquidity problems.** With the changing nature of liquidity, many funds' assets could potentially move from one bucket to another simultaneously and temporarily. When the thresholds are crossed due to a systemic deterioration of liquidity, OEFs would inevitably be obliged to sell the assets newly considered as illiquid in order to maintain their redemption policy. Instead of mitigating financial stability risks, the bucketing rules, when uniformly applied, could potentially worsen these risks.

Fundamentally, the value of one asset may experience "volatility jumps", i.e. market pricings are not stable processes and the labelling of one asset as liquid, less liquid and illiquid may be less relevant than a continuous monitoring of its valuation volatility, as well as the monitoring of the whole portfolio.

Moreover, FSB's proposal is that "each jurisdiction will need to determine its overall liquidity framework and an overall approach to defining assets as liquid, illiquid or less liquid (or comparable categories)." This could potentially lead to jurisdiction arbitrage.

AFG response

It is worth also bringing to FSB's attention the fact that the rules governing the redemption terms of funds cannot be modified seamlessly. In many jurisdictions, it cannot be done without the preliminary agreement of the supervisor and prior consent of the existing investors. Maintaining consistency between the redemption terms and the overchanging liquidity levels may be difficult to achieve. Consequently, the proposed bucketing approach which brings a strong link between asset liquidity and redemptions rules may be even difficult to implement practically.

Accordingly, AFG believes that introducing too prescriptive liquidity and quantitative recommendations on liquid buckets that could be translated into formal and similar rules for all funds is not the right approach, whereas the European regulatory approach is more justified. Regarding the definition of "liquid assets", AFG would like to recall that in Europe UCITS invest in assets which are considered liquid by nature. The frontier of the actual more or less liquidity in the market may fluctuate and we prefer in Europe to speak in terms of eligible or non-eligible assets as defined in the Eligible Assets Directive 2007/16/EC.

In complement of this directive, CESR's guidelines concerning eligible assets for investment by UCITS already provides very appropriate and detailed guidance regarding liquidity assessment of the fund's assets. To mention a few excerpts:

- If the security is assessed as insufficiently liquid to meet foreseeable redemption requests, the security must only be bought or held if there are sufficiently liquid securities in the portfolio so as to be able to meet the requirements of Article 37 of Directive 85/611/EEC.
- Where information is available to the UCITS that would lead it to determine that a transferable a security could compromise the ability of the UCITS to comply with Article 37 of Directive 85/611/EEC, the UCITS must assess its liquidity risk.
- The liquidity risk is a factor that the UCITS must consider when investing in any financial instrument in order to be compliant with the portfolio liquidity requirement to the extent required by Article 37.
- UCITS may not make investments in closed end funds for the purpose of circumventing the investment limits provided for UCITS by Directive 85/611/EEC.

Another important European peace of regulation is the ESMA Guidelines on Liquidity Stress Tests for Investment funds (September 2019) which adopt a proportionate approach to adapt to different investment strategies and underlying assets. Stress tests are strong risk management tools (including reverse ST) which help fund managers to anticipate liquidity shortages. Alternatively, well-designed investment strategies and activation of LMTs are key to manage liquidity crisis when they occur.

Q4. Should the FSB consider recommending the use of a decreased redemption frequency (on a standalone basis), a longer notice period (on a standalone basis) or a longer settlement period (on a standalone basis) for OEFs investing in less liquid assets that do not meet the expectation on the implementation of anti-dilution LMTs? Or should these measures be used in combination, considering the risk of redemptions crowding around certain dates?

AFG response

AFG is of the view that it is the good articulation between these measures that really matters. All parameters should not be set independently from one another, but on the contrary, be articulated with each other in a holistic manner, providing a sound and consistent liquidity policy. In this respect, preserving the AM discretion to design and implement the liquidity policy is important.

For less liquid assets, a longer notice period proved to be useful but it should not be set independently from the redemption frequency and the settlement period.

Q5. Would additional guidance on factors to consider when setting the redemption frequency or notice or settlement period be helpful? If yes, in what respect?

AFG response

AFG acknowledges that the proposed factors make sense. However as previously explained, AFG is not in favor of imposing fixed ratios or parameters as there is a need to be assessed in an holistic manner.

Liquidity management tools (Recommendations 4, 5 and 8)

Q6. Do the proposed changes to Recommendations 4 and 5, when read together with the proposed IOSCO guidance on anti-dilution LMTs, help achieve greater use and a more consistent approach to the use of anti-dilution LMTs? If not, what changes should be proposed to the FSB Recommendations?

AFG response

AFG concurs with the two revised recommendations, notably on the extended use and availability of LMTs in all jurisdictions and on the need to select at least one anti-dilution tool for most OEFs with some documented exemptions.

For instance, AFG believes that funds investing in very liquid asset classes (such as “blue chip” equity) may not need to rely on specific mechanism to ensure a fair treatment of the investors. Anti-dilution tools may thus not have additional value for such funds (investing in extremely liquid assets)

Anti-dilution tools should rather be implemented with liquid asset classes that can have wider bid-ask spreads at times (credit, HY, small cap, convertibles).

AFG recommend pragmatism in the effective implementation of anti-dilution tools and we note that IOSCO’s framework provides for a best effort basis approach with (1) a robust supervisory framework by the firm and (2) the necessity to use estimates and improve the quality of such estimates over time.

Q7. Are there any obstacles (either universal or jurisdiction specific) to the implementation of the revised FSB Recommendations on the use of anti-dilution LMTs? If yes, what additional recommendations or guidance would help address such obstacles?

AFG response

LMTs volumes seem to be manageable today. However, it may be problematic in case of significant increases in volumes.

Another obstacle is the access to reliable data for explicit and implicit costs, especially for bond funds.

AFG would also like to mention that anti-dilution mechanisms such as swing pricing have a cost of implementation and a cost of operation, and can also generate operational risk, in particular in the process of NAV calculation.

It they were forced to implement anti-dilution LMTs, smaller asset manager which do not have the IT resources to develop highly industrial processes may bear a disproportionate cost compare to the added value of the LMT in certain cases.. Our opinion is that in the cases where the mechanism advantages are not considered significant (i.e. for funds invested in large cap equities) regarding the cost and risk of the mechanism, the asset manager shouldn't be forced to include them systematically.

Q8. Would additional recommendations or guidance be helpful in clarifying the expectation that OEF managers have internal systems, procedures and controls enabling them to use anti-dilution LMTs as part of the OEFs' day-to-day liquidity risk management?

AFG response

The risk management policy, which encompasses the liquidity risk management, is a very important tool to explain the asset managers procedures. Its governance and update are essential points.

Q9. Do you agree with applying anti-dilution LMTs to subscribing investors as well as to redeeming investors? If not, why?

AFG response

In principle, the protection of investor interests requires that anti-dilution LMTs do apply for both redeeming and subscribing investors. For subscriptions, it should be noted that there are already other management tools to address them (e.g. derivatives contracts can temporary be used to gain immediate exposure at low cost). Thus, flexibility should be left to AMs to use anti-dilution tools in addition to, or instead of, such existing tools in case of subscribing investors.

Q10. Would additional international guidance on the availability and use of quantity-based LMTs be useful? If yes, what aspects should such guidance focus on? If not, why?

AFG response

Some jurisdictions would have their learning journey facilitated by high level guidelines on the technical aspects on the LMTs implementation. This will also contribute to a level playing field between all jurisdictions.

AFG fully agrees with FSB when it states in its Nov. 2022 Progress Report on "Enhancing the Resilience of NBFI" that "When LMTs are available, cost, competitive or reputational concerns, as well as operational hurdles, may have prevented OEF managers from including them in OEF constitutional documents or using them."

Such aspects like reputational concerns or operational hurdles should be a matter of focus insofar as they sometimes restraint OEF managers from adopting quantity-based LMTs.

Other FSB Recommendations

Q11. Do the proposed changes to Recommendation 2, when read together with the proposed IOSCO guidance on disclosure to investors, help enhance disclosure to investors on the use of anti-dilution LMTs? If not, what changes should be proposed to the FSB Recommendations?

AFG response

AFG agrees with the recommendation to provide further information on the availability and use of LMTs to investors. However, too granular information (as the detailed proposed guidance no 6 by IOSCO) may be difficult to assess by end investors.

Moreover, AFG believes that liquidity risk management details must remain non-public, but made available to regulators. Some confidentiality should be kept so as not to undermine the efficiency of the risk measure. For instance, AFG backed by AMF has issued Guidance regarding the swing pricing mechanism (Swing pricing and ADL : code of conduct for asset managers) where the manager is encouraged to give "only general principles of the chosen methodology. Furthermore, it should not disclose parameters that are too detailed and recent and that would enable an investor to amend his/her subscription or redemption strategy by taking advantage of more advantageous conditions. This would thus reduce the Swing Pricing mechanism's efficiency. In particular, the management company should not communicate (in writing or orally) the current levels of the trigger thresholds. To this end, it notably ensures that the internal circuits of information are restricted to favour the conservation of the confidential character of this piece of information."

In addition, disclosures on the liquidity risks should not isolate and overemphasize this risk in particular compared with the general risk and return profile of the fund.

Q12. Should any other 2017 FSB Recommendations (Recommendations 1, 6, 7 or 9) be amended to enhance the clarity and specificity of the intended policy outcomes? If yes, which ones and why?

AFG response

Given the fast-evolving practice of market participants in the use of LMTs, AFG sees benefits in having regular peer reviews among the jurisdictions.

Additional considerations

Q13. Are there any other aspects that should be considered in the revised FSB Recommendations to ensure that they are effective from a financial stability perspective?

AFG response

Recommendation 3 puts an emphasis on the consistency between the redemption terms and the liquidity of the assets. Liquidity on the liability side is also a matter of importance. As described in the AFG guide (Practical guide to liquidity risk management compliance), measuring liquidity on the liability side aims at estimating the redemption risk that the fund could be subject to. It is an important element to take into account at the design phase and on an ongoing basis (while taking into account the difficulty to access to granular liability data at fair cost from intermediaries, which is a point where regulators/legislators may have a high impact). Strictly speaking, potential liquidity mismatch can stem from the discrepancy on asset/liability matching. Permanent liquidity assessment and stress testing should be carried out on both sides.

As stated earlier, AFG would like to recall that knowledge on the investors' base is still at work, at a very early stage until the ecosystem is willing to accept to give at free/reasonable cost the information on end-clients and not invoke confidentiality reasons.

There is another aspect which should also be considered is the scope of scrutiny. Indeed, NBFIs gather a great variety of financial institutions which could be split between regulated and non-regulated players. The lack of regulation implies by construction a lack of supervision. Consequently, the non-regulated fund sector should be matter of an enhanced focus.

AFG

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