Addressing liquidity mismatches

Financial Stability Board (FSB) consultation on revisions of 2017 policy

This paper has been prepared in response to: *Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations: Consultation report*.

The Association of Investment Companies (AIC) agrees that the FSB should seek to significantly strengthen liquidity management practices adopted by open-ended fund (OEF) managers. OEFs are increasingly holding less liquid assets. This, alongside digital transaction options which allows investors to redeem OEFs very quickly in huge volumes, has significantly increased the systemic liquidity risks created by the sector.

Liquidity risks presented by OEFs have also increased as market and economic circumstances have changed. In turn, this is likely to change the liquidity profile of assets and it remains a concern that these factors have not been sufficiently recognised and absorbed by those considering their liquidity management arrangements.

The need for robust liquidity management systems is especially acute in the UK because of the policy decision to deepen OEF investment into inherently illiquid assets. This has been exemplified by the creation of the Long-Term Asset Fund (LTAF), which is an untested open-ended structure designed to hold illiquid assets. The regulatory framework for LTAFs seeks to mitigate liquidity mismatches, but, if material liquidity risks are to be prevented from crystalising, fund operators must have robust system in place to understand, monitor and manage these issues. It remains to be seen if this will be achieved. The LTAF rules give operators flexibility in key areas, notably setting notice periods. Enhanced FSB/IOSCO guidelines will be important in setting expectations and standards which may help ensure that the approaches they adopt are sufficient.

The AIC remains concerned that too frequently asset managers exhibit liquidity optimism. That is, they consider that assets will have higher liquidity than is the reality. This optimism is particularly pronounced where external economic circumstances and investor sentiment will affect both transaction times for the assets and demands for redemption.

Liquidity optimism is inevitable because of a tension between the commercial incentive to offer redemption terms which are attractive to investors and a realistic assessment of the time it would take to sell a representative slice of underlying assets (including holdings with the least liquidity). The former too often overrides a realistic assessment of how long it may take to liquidate assets if market conditions are not optimal. UK regulators (the Financial Conduct Authority, and the Bank of England) have reviewed liquidity issues. They identified liquidity optimism as an issue.

The AIC explored these issues in *An accident waiting to happen: the dangers of selling LTAFs to retail investors and how to reduce them*. More recent findings from the FCA confirm that asset managers continue to have lessons to learn about liquidity management.

In a letter to chief executives of firms the FCA set out the findings of a Liquidity Management Multi-Firm Review. It found a wide range of quality in standards of compliance and liquidity management experience saying that "*Most firms fell short in some aspects of their framework*".

The FCA also noted that “*many firms attach insufficient weight to liquidity risk management in governance arrangements*”.

Updated guidance on liquidity risk management from the FSB and IOSCO should seek to address these serious flaws.

Consultation questions

1. 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?

Yes, it would be helpful to provide more guidance on what stressed market conditions comprise. Too often normal market movements, which should be expected to include periods of sustained falling asset values and persistent redemption requests, are used to justify the use of exceptional liquidity management mechanisms.

Redemption mechanisms should be able to operate through periods of expected/normal market falls. Without guidance on stressed conditions – particularly ‘normal’, albeit adverse, conditions - fund operators are unlikely to develop liquidity arrangements adequate to operate during these less positive periods. An expectation that exceptional measures, such as fund suspensions, may be used increases the systemic liquidity risks of OEFs. This expectation creates strong incentives for investors to be first movers in leaving a fund facing liquidity pressures.

Where one fund has lax arrangements, their competitors have strong incentives to do the same. The commercial costs of more robust arrangements (arising because investors choose the more attractive redemption option) are immediate, as it reduces market share. The costs of inadequate liquidity arrangements are less immediate. They are likely to crystalise less frequently – after the rewards of operating an OEF (fee receipts) have been secured. Also, a significant part of the costs of failed redemption arrangements (being unable to exit, and exposure to falling asset values) fall on the investor not the fund operator. Indeed, during a period of suspension the operator may be able to continue to receive fees. If competitors are also suspended, it is easier to explain away the exceptional measures as being the result of exceptional/market wide stresses.

This position was seen in UK OEFs offering access to property. The sector developed offering daily liquidity (despite the evident liquidity mismatch this reflected). In recent years, OEF holding real estate saw liquidity mismatches crystalise, which led to widespread suspensions. During the least ten years, much of the sector was suspended for approaching a quarter of the time. Except for part of the COVID-19 period, these suspensions were applied in periods where the market was not exceptionally stressed. While funds were suspended, it was investors which suffered the full consequences. Daily trading arrangements have yet to be unwound in the open-ended property sector. This is despite the continuing risks they present in relation to the potential for forced asset sales depressing market values and creating wider systemic instability.

The lack of guidance on stressed market conditions makes it easier for the inherent liquidity optimism of fund operators to influence OEF design. Design flaws within OEFs (notably, inadequate notice periods) are more likely to trigger the use of exceptional liquidity

management tools. This is evidence of inadequate arrangements – not evidence of exceptional periods of market stress.

Investors wanting to exit an OEF on the terms offered should not be considered a stress event. It should be external conditions, which are not reasonably expected across the economic cycle, which allows the use of additional liquidity management tools.

The AIC **recommends** that FSB/IOSCO guidance should explore what stressed market conditions are. This should include a view on when conditions become sufficiently stressed to justify the use of exceptional, or additional, liquidity management tools. After all, if OEF redemption arrangements cannot operate reliably over the economic cycle, and the expected holding period of a long-term investor, then they are inadequate. Otherwise, they will invariably incorporate first mover incentives, which create systemic risk.

2. 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?

There are many factors which affect liquidity. Different issues will arise in different asset classes.

Factors include how changes in the risk-free rate of return (interest rates) will influence the relative attractions of assets, particularly those with fixed returns. Changing interest rates may make the returns of risky assets intrinsically unattractive if a higher return can be secured without risk. This will make them difficult to sell without significant discounts. Interest rate changes may also have a significant impact on the attractions, and therefore liquidity, of assets exposed to leverage.

Economic conditions affecting stock market risks and returns will also affect the relative attractions, and liquidity of less liquid investments.

Valuation uncertainty and due diligence requirements for idiosyncratic holdings are also critical. Any asset where there is a significant lack of public information about the nature of that holding, and comparative data on similar assets, is likely to exhibit limited and variable liquidity. These liquidity considerations will change throughout the normal progression of the economic cycle.

Any factor where there is the potential for competing judgements to be made on the value of an asset, will affect the liquidity of specific holdings and asset classes.

3. 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?

The use of specific thresholds should be approached with caution. There may be some value in thresholds as a tool for designing redemption/liquidity arrangements. However, there should be no presumption about the dealing frequency.

There should be no presumption, for example, that a fund with 50% of liquid assets should be daily dealing. The OEF operator should be able to sell from the least liquid 'bucket' of the portfolio or else the arrangements are inherently unstable.

A fund may start as 50:50 liquid:illiquid. However, where there is persistent redemption demand the liquidity portion of the portfolio may erode. The less liquid part of the portfolio may be exposed to valuation uncertainty and falling values. This creates clear first mover incentives, which will destabilise the fund.

This potential was seen in the experience of Woodford Equity Income Fund (WEIF). It was intended to have only 10% in illiquid assets and offered daily redemption. When investors decided to exit the fund, the structure was progressively destabilised until it was forced to close. By the time the fund closed it had significantly breached that 10% limit. A fundamental problem was that the redemption requests were being met from the liquid assets. As assets were sold, the character of the portfolio shifted, which created incentives to leave.

The FCA wrote a letter to MPs explaining how the liquidity profile of WEIF changed as investors made sustained redemption requests and how this affected the integrity of the fund.

Similar risks and issues would arise if guidance specified that a OEF with 50% illiquid assets could have daily dealing. When sentiment moved against the OEF, it would become inherently unstable. What was intended to be a fund with 50% liquid assets could become one with 30% liquidity, or less.

With this in mind, it may be appropriate to establish specific thresholds to base the assessment of liquidity on, but this should not lead to any presumption about dealing periods. The OEF must base redemption arrangements on the need to sell the least liquid assets to maintain the liquidity profile of the fund.

The AIC agrees that where structures are intended to hold a significant proportion of illiquid assets, then redemption and frequency should be reduced, and notice periods lengthened. It is also appropriate to recommend that regulators and operators should consider whether a closed-ended structure would be more appropriate for the intended assets.

4. 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?

Liquidity management tools should be used in combination to achieve a reliable redemption mechanism (which does not crystalise liquidity risks). However, the most critical tool is setting notice periods which realistically reflect the time taken to sell assets, across the economic cycle, without a material discount. Where less liquid assets are held, the notice period set should represent the time taken to sell assets from the least liquid part of the portfolio. If this is not the position, then the liquidity of the portfolio will concentrate over time, and the arrangements will be inadequate to prevent liquidity mismatches.

The frequency of redemption is also relevant and should be calibrated to the time taken to liquidate assets.

The AIC is sceptical that anti-dilution measures will mitigate structural liquidity mismatches where assets are inherently illiquid. The ambition is to ensure that investors leaving the OEF bear the costs of their redemption. It is unclear that this is possible. Transaction costs may be uncertain. Where there is a time pressure, assets may be sold at deep discounts and there may be uncertainty about valuation of assets.

If redemptions are sought because of wider pressures, for example, investors de-risking or selling a fund because of poor performance, then the use of anti-dilution mechanisms is unlikely to help address structural liquidity mismatches. They could make the position of the OEF less stable if they exacerbate fist mover incentives, in turn encouraging unsustainable redemption levels and increasing the risk of crystallising liquidity mismatches.

Systemic risks will arise if pricing adjustments increase rates of discounted asset sales, and result in negative, pro-cyclical pressure on asset values.

Square peg in a round hole: tackling the dangers of holding illiquid assets in open-ended funds, discusses the problems of using pricing adjustments to manage liquidity where an OEF holds inherently illiquid assets (Page 30)

Insofar as there is guidance on anti-dilution tools, it should emphasise the risks and limits of using these mechanisms. It should emphasise that these tools are less suitable for the least liquid assets, where valuations may be uncertain, and transactions take the longest time to complete.

5. Would additional guidance on factors to consider when setting the redemption frequency or notice or settlement period be helpful? If yes, in what respect? Liquidity management tools (Recommendations 4, 5 and 8)

Yes, further guidance would be of assistance. It should make clear that normal tools (such redemption frequency and notice periods) should be sufficiently calibrated to prevent the use of additional tools (suspension and lengthy deferrals) in normal market conditions (including poor markets). A deferral for a day is unlikely to have a material impact, and therefore would not be exceptional. However, a deferral for longer than the next trading day (and certainly anything amounting to 30 days or more) creates first mover incentives and should be identified as an exceptional liquidity management tool.

Additional tools (including suspensions and lengthy deferrals) should only be deployed in exceptional market conditions. They should not be deployed because of persistent, reasonably expected, redemption demands.

6. 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?

The AIC supports the IOSCO guidance on anti-dilutions LMTs.

7. 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?

The AIC has no comments on this question.

8. 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?

The recommendations should specify the situations where anti-dilution LMTs may not be appropriate for OEFs. This might include discussing the characteristics of assets which may make them inappropriate and whether their use in conjunction with other LMTs may make them ineffective or exacerbate structural liquidity risks.

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

The AIC has no comments on this question.

10. 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?

Yes. The issue of deferrals is significant in this context. Deferral to the next business day, or a few days, is not significant. Deferral to a dealing point 30 days (or more) away should be considered exceptional. When an investor is seeking to de-risk or stop a loss, the prospect of a deferral of this length creates first mover incentives.

The potential for repeated, lengthy deferrals will also exacerbate first mover incentives. In effect, arrangements become suspensions by another name. Managers may even find these arrangements commercially attractive, as they can still receive subscriptions, even though investors may view the prospect of their use very negatively.

11. 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?

Enhanced disclosure on anti-dilution LMTs is appropriate. Investors should be aware of what they are buying into. Transparency may ensure that these LMTs are fair and well-constructed.

Unfortunately, this also creates risks. Where an OEF is in the position of having to sell assets to meet redemptions, investors will be able to see the risks created by anti-dilution tools (particularly if they are poorly constructed). In particular, the likelihood that remaining investors will not be fully compensated for the costs of providing redemption. This will increase first mover incentives. However, disclosure will create incentives to apply tools effectively. Lack of disclosure is likely to result in stronger first mover incentives.

12. 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?

As discussed above, the position of deferrals, and the circumstances when these arrangements should be additional LMTs should be discussed. Any LMT which creates material first mover incentives should only be used in exceptional circumstances. They should not be intended for use in normal market conditions, including normal stressed market conditions. This should be clarified.

13. 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?

There should be a clearer view on which LMTs can be used as part of the expected operation of an OEF's liquidity arrangements and which are used only in exceptional circumstances. The intention should be to manage OEFs without use of additional tools. The only time they should be used is in exceptional and/or unforeseeable events.

The experience of the COVID-19 pandemic would be a good example of events which are exceptional/unforeseeable. The impact of this on valuations and markets was self-evidently of a magnitude to justify use of exceptional tools.

Industry has been more prepared to use exceptional tools more frequently. Property funds suspended after the vote of the UK to leave the EU. This was far from an unforeseeable outcome – the vote was well publicised, and the option (leave or not) was binary. Yet this resulted in lengthy suspensions.

Fund suspensions simply because investors want their money in reasonable volumes, are not justified. OEFs should be able to deliver, for example, 15% redemption requests in any one dealing window without the use of exceptional LMTs.

1 September 2023