FSB FINANCIAL STABILITY BOARD

20 December 2023

Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations

Summary of consultation responses and changes to address them

1. Introduction

The FSB's consultation report with policy proposals to address structural vulnerabilities from liquidity mismatch in OEFs was published on 5 July and the comment period closed on 4 September 2023.[1] The objective of the consultation was to get stakeholder feedback on the proposed manner of implementing the recommendations on follow-up policies, as described in the report on the assessment of the effectiveness of the FSB's 2017 recommendations on liquidity mismatch in open-ended funds.[2]

This note provides a summary of the feedback received on the consultation report and informs how it has been addressed in the final report.

25 responses were received to the consultation, the majority of which came from fund managers and their trade associations in the United States and Europe. All responses are available on the FSB website. In addition, the FSB organised a hybrid public outreach event on 12 July in Dublin to gather preliminary feedback on the consultation report shortly after its publication. Annex 1 includes the consultation questions.

2. Summary of feedback received

2.1. Overall

Comments received

Most respondents, including those from the asset management industry, generally supported the policy objective to better align the liquidity of fund assets with fund structures, dealing terms and LMTs available to fund managers. Some of them agreed that enhancing investor protection

1 See FSB (2023), *Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations: Consultation report*, July.

2 See FSB (2022), *Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds*, December.

and enhancing financial stability are complementary objectives, and strengthening liquidity management practices in OEFs would help achieve both.

Respondents generally supported the exclusion of money market funds and exchange-traded funds from the scope of the Recommendations, as well as the proposal not to include minimum regulatory requirements for liquid asset holdings across the fund sector.

Most respondents agreed that OEF managers are best placed to manage the liquidity of their portfolios and that there cannot be a "one-size-fits-all" approach. They considered that OEF managers should have discretion on whether and which liquidity management measures and tools to use. In particular, they opposed the proposal that all OEF managers must consider and use an anti-dilution LMT (ADT). As examples, they cited funds with low expected dilution levels such as large cap equity funds; or funds where there would be no first-mover advantage (FMA) such as single-investor funds or funds that already have appropriate liquidity management measures to address liquidity mismatch, such as real estate funds that do not have daily dealing and have notice periods.

Most respondents strongly opposed the proposed bucketing approach, especially the use of hard thresholds. Some respondents highlighted that data or examples should be provided to support the choice of the thresholds. A few respondents suggested that policymakers should collect and analyse high-quality data to assess OEF vulnerabilities.

Finally, when asked whether there are other aspects that should be considered in the revised Recommendations to ensure that they are effective from a financial stability perspective, one respondent suggested to focus on financial products with potential weaknesses, such as products with high amounts of leverage, concentrated investor bases, and large quantities of illiquid securities during periods of market volatility. A few respondents questioned whether liquidity mismatch in OEFs is a vulnerability that can expose the financial system to financial stability risks. However, discussing the policy objective of addressing this vulnerability – which had been outlined in the FSB's December 2022 report on Assessment of the Effectiveness of the FSB's Recommendation on Liquidity Mismatch in Open-Ended Funds – was outside the scope of the public consultation.

Changes in response to comments

In relation to the comments that are not strictly linked to the consultation questions, the FSB included a statement upfront to set the scene that the objective of the Revised FSB Recommendations is to drive a significant change/improvement in addressing the liquidity mismatch issue and that status quo is not expected.

2.2. Structural liquidity mismatch (Recommendation 3)

Comments received

Overall, most respondents opposed the proposed bucketing approach, though not universally. Specifically, one industry body and one large asset manager were open to the idea in principle, though the asset manager suggested a different categorisation ("liquid" and "illiquid"). A lot of the responses to the questions did not actually answer the specific question but rather commented on wider policy points.

Specific concerns with Recommendation 3 can be separated into (1) concerns with the idea of bucketing itself; and (2) the implementation of the bucketing proposed.

In terms of the substance, many concerns were expressed that the approach to bucketing was too rigid and failed to recognise the dynamic nature of liquidity. In particular, some respondents considered that the determinants of the liquidity of an asset might change over time and that market liquidity depends on factors varying across time and circumstances, and therefore expressed concerns that there would be no guarantee that past levels of liquidity provide a meaningful indication for the future. Some respondents claimed that the bucketing approach might cause confusion among investors and pose undue constraints on a fund's dealing frequency, whilst others suggested that the use of specific thresholds could lead to first mover advantage issues. Some respondents did not fully understand the boundary between categories 1 ("liquid") and 3 ("less liquid") with respect to policy expectations.

On specific implementation issues, some respondents expressed concerns that the transition between different buckets, which they thought could occur on a daily basis or even intraday, would pose operational hurdles and confuse investors. The transitions between buckets would also be costly for asset managers and could even trigger forced sales if investors seek to redeem from a fund that is re-classified. One respondent questioned whether there would be a consistent approach by jurisdictions to implementing the bucketing approach, which, if not done, could lead to market fragmentation. On the specific questions, the majority of views on question 1 was that further descriptions of "normal" and "stressed" market conditions were not needed/would not be helpful, though a minority of responses said high-level principles might be helpful (see Annex 1 for the list of consultation questions). For question 2, several respondents noted that the examples of factors for determining liquidity were appropriate, but not exhaustive and could change over time. Several respondents however opposed them or did not respond directly, consistent with their wider opposition to the bucketing approach.

The approach to specific thresholds as the way of implementing the bucketing approach was almost unanimously opposed. While respondents opposed bucketing altogether, even those who were open to it in principle suggested a less prescriptive and more principles-based approach to categorising OEFs. Most respondents did not respond to question 4 directly, but instead stated that liquidity management was best left to the discretion of individual fund managers.

Many responses suggested that longer notice and settlement periods are more effective tools than dealing and/or redemption frequency, warning about excessive focus on the latter. There were mixed views on the usefulness of additional guidance on factors to consider for setting the redemption frequency and the length of notice and settlement periods. One large asset manager suggested that while additional guidance would be helpful, it should provide the greatest possible flexibility to managers.

Respondents agreed on making a broad range of liquidity management tools available to fund managers but believed the approach should be principles-based and allow for flexibility so that OEF managers have the discretion to implement LMTs appropriately.

Changes in response to comments

In response to the comments made, the FSB sought to clarify the bucketing (or 'categorisation') framework and provide more flexibility to authorities in implementing the framework in their respective jurisdictions. The main revisions made to Recommendation 3 are.

- Clarifying that different tools and measures are envisaged for different categories of funds depending on the asset liquidity profile. As a result, there are different expectations for the three categories in respect of tools – including on the implementation of ADTs.
- Clarifying the role of authorities and fund managers in categorising funds in the three categories. More specifically, the revised report notes that fund managers would determine the categorisation of their fund(s) based on the domestic framework as set out by the authorities.
- To address concerns related to unintended effects from potential frequent re-categorisation of funds across categories, the report clarified that funds are not expected to re-assess the asset liquidity profile (and associated categorisation) and re-align it with the redemption terms and implementation of ADTs on an intraday basis or on very frequent terms. In addition, the report specified that jurisdictions should provide some degree of flexibility to address movements by OEFs between the different categories.
- Given the strength of opposition to using specific quantitative thresholds as the basis for implementing the categorisation approach, the report is setting out indicative guidelines to drive more international alignment for what the thresholds should be, but this would be for authorities to determine as appropriate in their own jurisdictions. When the Revised FSB Recommendations will be operationalised by IOSCO, criteria and principles can be developed to achieve a more consistent implementation.
- In terms of presentation, consultation report's Category 2 ('illiquid') and Category 3 ('less liquid') were swapped. The report now presents the categories in a more logical order, based on descending level of liquidity.
- For simplicity, in the final report the word "bucketing" was replaced with the word "categorisation".

2.3. Liquidity management tools (Recommendations 4, 5 and 8)

Comments received

While there was general support with the objective to broaden availability of LMTs, most respondents objected the proposal to have managers consider and use ADTs for all OEFs and suggested that managers should have the flexibility to determine whether or not ADTs should be adopted. They argued that ADTs were not necessary, relevant or feasible for certain types of funds, for example, funds investing in very liquid assets like blue-chip stocks where the dilution impact of sales to meet redemptions has been minimal and real estate funds, where redemption frequency is generally not daily and other LMTs or measures (e.g., notice periods, gates, deferred settlements) are in place and are more commonly used.

In addition, some respondents noted that the granularity of the recommendations (and the IOSCO guidance) is an obstacle to implementation as it strips managers of their discretion to manage liquidity of their funds and may result in a breach of their fiduciary duties (e.g., managers may run the risk of overestimating the cost of liquidity for ADTs based on the approach suggested in the draft FSB Recommendations and IOSCO LMT Guidance and hence 'penalise' redeeming investors). Even though some respondents believed that additional guidance would be helpful in clarifying the expectations on them, many respondents found the recommendations (and the IOSCO LMT Guidance) to be overly prescriptive and underestimating the complexity and challenges in administering ADTs.

Some respondents also objected to the mandatory inclusion of market impact in the calculation of transaction costs. These respondents cited difficulties in obtaining reliable and timely data as a major obstacle to estimate liquidity costs at the time of the subscription or redemption, particularly for bond funds. Some respondents also mentioned that in some jurisdictions, significant changes to infrastructure and processes at jurisdictional or market level would be required to overcome these issues. Many respondents also warned that administering systems to estimate market impact is complex and resource-intensive and some smaller or less sophisticated managers may bear a disproportionate cost in developing those systems and processes as compared to the added value of the ADTs.

There were mixed views on whether ADTs should be applied to subscribing investors as well as redeeming investors. Those in support believed that liquidity costs are incurred for both buy and sell transactions and there is a risk of dilution regardless of the direction of net flows; however, many of these respondents suggested that it should be left to the manager to decide whether to apply ADTs to subscribing investors. Those who objected did so either on the basis that managers are not subject to the same timing and cash utilisation pressures for subscriptions as compared to redemptions or they did not agree with the recommendation that OEFs should adopt ADTs at all.

Overall, there were significant concerns that the costs of implementing the recommendations on ADTs, taking into account the specifics set out in the IOSCO LMT Guidance, may far outweigh the perceived benefits in certain cases. Therefore, many respondents asked for flexibility in the implementation of ADTs. In the opinion of some respondents, the materiality of any dilution and the first mover advantage have not been established. Some respondents also mentioned that, in certain jurisdictions, there are significant operational barriers to accessing certain types of data, in particular the availability of same-day fund flow data, due to the characteristics of the fund ecosystem in those jurisdictions.

A majority of respondents supported having international guidance on the availability and use of quantity-based LMTs. They believed that additional guidance would help to ensure a greater availability and implementation of LMTs, reduce local markets' regulatory impediments and contribute to level-playing field among jurisdictions, including consistent disclosure. These respondents stressed that such guidance should remain principles-based since fund managers are best placed to manage liquidity. One respondent pointed out that authorities have nevertheless a role to play on LMTs not only during the fund's authorisation phase but also on an ongoing basis to ensure that managers are operationally prepared to use LMTs. A few respondents did not believe additional guidance was necessary, citing the adequacy of existing guidance and the heterogeneity of markets.

Changes in response to comments

In response to the comments made, the FSB made the following changes:

- The report further clarifies the policy intent of the recommendations by referring to Recommendation 3 where the focus of greater use and greater consistency in the use of ADTs is on Category 2 ('less liquid') funds, given that is where the financial stability concerns arising from potential liquidity mismatch remain the most pronounced.
- More specifically, the report clarifies that the expectation is that ADTs would be increasingly used by Category 2 funds as part of their day-to-day liquidity management, unless such LMTs not being used is clearly justified, subject to (i) oversight of authorities in line with their supervisory approaches and (ii) implementation of other effective liquidity risk management measures that meet the broader policy intent of reducing material structural liquidity mismatches underpinning the Revised FSB Recommendations.
- References to the application of ADTs to subscribing investors were removed.

2.4. Other FSB Recommendations and additional considerations

Comments received

Most respondents agreed with the proposed changes to Recommendation 2, which would help enhance disclosures to investors on the use of anti-dilution LMTs. Enhancing disclosure is appropriate and more transparency would lead to fair, well-constructed LMTs and likely reduced first mover incentives. However, the majority of these respondents suggested that disclosing granular information, e.g. on calibration and activation thresholds, would be either ineffective (because too difficult to assess by non-sophisticated investors) or possibly counterproductive, if more sophisticated investors were able to exploit granular information to 'game' and anticipate the activation of tools. One respondent recommended more disclosure on past activations of anti-dilution tools.

In their reply to consultation question 12 (possible amendments to 2017 FSB Recommendations 1, 6, 7 or 9), a few comments were made. Some noted that more guidance would be welcome on quantity-based LMTs, which should be applied more consistently across jurisdictions; while acknowledging that market liquidity conditions are affected by the behaviour of a wide set of market participants. A few respondents were not particularly in favour of system-wide stress tests, as current modelling techniques as well as data needed to calibrate models are still not sufficient.

Finally, several respondents reiterated the need to close data gaps, including those on portfolios and trading activity for vehicles other than OEFs, as well as recognising the critical role of intermediaries (such as banks) and market structure. Enhancing transparency, e.g. by facilitating access to consolidated tapes of pre- and post-trade data, was mentioned as another factor that would help improve market liquidity conditions.

Changes in response to comments

In response to the comments made, the FSB made the following changes:

- Clarified possible trade-offs associated to disclosure of use of ADTs;
- Expressed support for guidance on use of quantity-based LMTs; and
- Stressed further the need to close data gaps, which would facilitate use and development of fund and system-wide stress tests.

Annex 1: Questions of the consultation report

Structural liquidity mismatch (Recommendation 3)

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?

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?

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?

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?

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)

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?

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?

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?

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

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?

Other FSB Recommendations

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?

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?

Additional considerations

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?