LIQUIDITY MANAGEMENT: A STATE OF MATTER

CLEAR DOCUMENTATION
Pointing to full processes and policies

LIQUIDITY ASSESSMENT
Maintained throughout the fund lifecycle

APPLYING LIMITS
Categorised by threshold or bucket

BEING PROACTIVE
Identifying issues and mitigating actions

INVESTOR OUTCOMES
Aligned to redemption expectations

STRESS TESTING
Covering back- and forward-looking scenarios

INVESTOR DISCLOSURE
Clearly explaining processes in place

GOVERNANCE FRAMEWORKS
Including senior oversight and pushback

OVERSIGHT
By everyone with fiduciary responsibility

US
SEC
Liquidity buckets and monitoring industry progress

INTERNATIONAL
G20, FSB, IOSCO
Market fragmentation and bond market assessment

EUROPE
ESMA
Liquidity stress testing and stress-simulation framework

HONG KONG, SINGAPORE
SFC, MAS
Liquidity management remains a key focus

CHINA
CSRC
Seeking opinion on a possible side-pocket mechanism

As more liquidity management questions arise in the world of investment funds, the beginning of 2020 will see a review of how IOSCO's 2018 recommendations were put into practice.

INTERNATIONAL

LIQUIDITY MANAGEMENT: A STATE OF MATTER

Water – we tend to experience it most in its fluid form. But like so many other substances on earth, it can change state with the addition (or the subtraction) of energy.

- In liquid form, it's water.
- In solid form, it's ice.
- When heated, it's vapour.

Well, the same might be said of money: what is liquid can become illiquid – and vice versa – under certain conditions, if arguably less uniform ones than those governing the natural world. In this article, we consider some of the recent regulatory attention directed at liquidity management in the world of financial services along with a high-level comparison of requirements across key jurisdictions.[1]

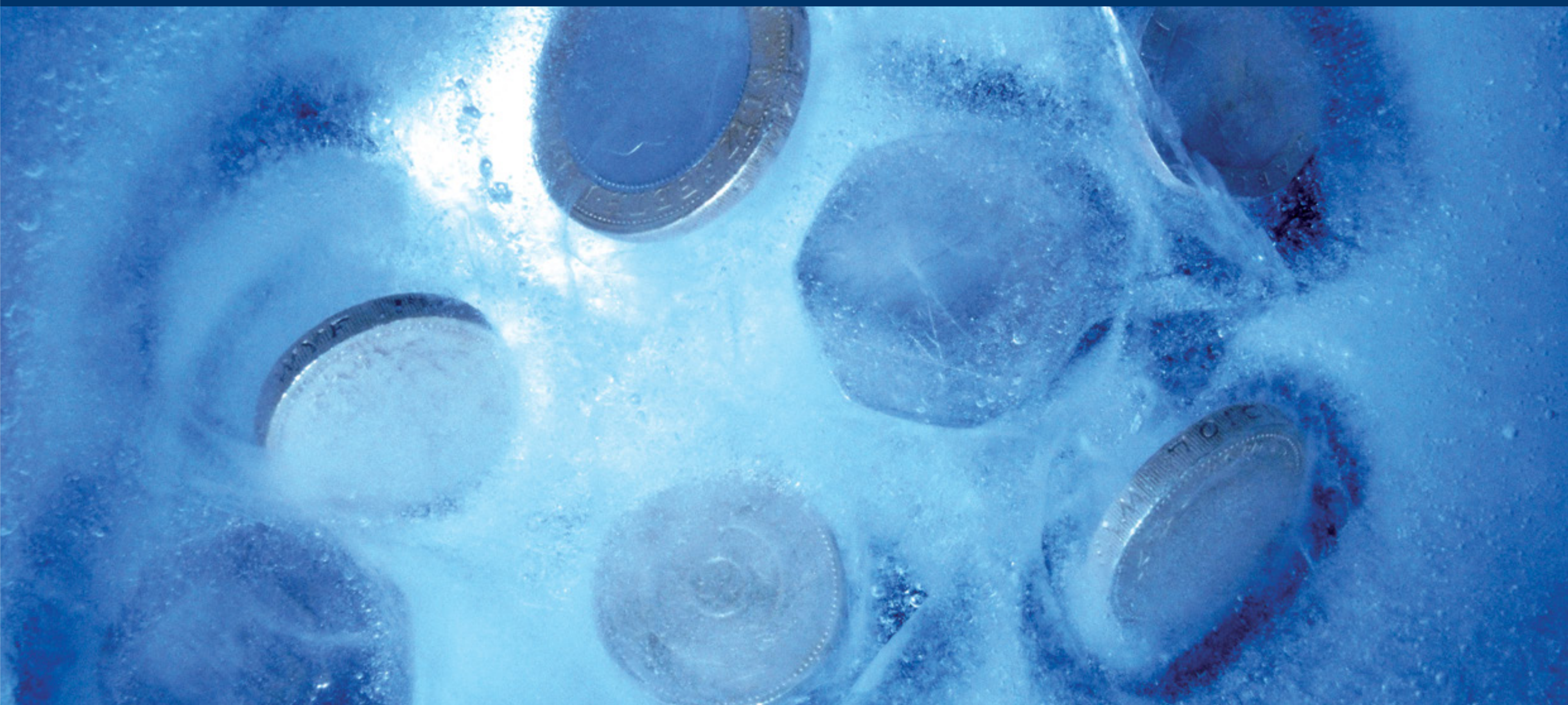
Deepening examination of potential systemic risks

For some time, regulators have been deepening their examination of systemic risks in the asset management sector, focusing on liquidity and leverage.

We saw this recently when the Bank of England's governor, Mark Carney, mentioned the word "systemic" in relation to funds and potentially "risky" investments during a Q&A session in front of British Members of Parliament.[2]

The U.S. Federal Reserve also highlighted liquidity risk in bond and loan mutual funds in its May financial stability report.[3]

But is there genuine cause for alarm for the current state of liquidity within investment funds available to retail investors, such as UCITS? This is a question that continues to be debated.



Recent regulatory analysis and guidelines

The asset management industry encompasses a wide variety of business activities, ranging from traditional asset management to alternative investing and direct lending. Ways in which the asset management industry might act as a catalyst or contributor to systemic risk is now being addressed at an international level.

Financial Stability Board (FSB) Policy recommendations to address structural vulnerabilities from asset management activities, Jan 2017

FSB identified structural vulnerabilities:

1. Liquidity mismatch between fund investments and redemption terms and conditions for open-ended funds
2. Leverage within investment funds
3. Operational risk and challenges at asset managers in stressed conditions
4. Securities lending activities of asset managers and funds

ISOCO recommendations and good practices to improve liquidity management for investment funds – Final Report, Feb 2018

IOSCO additional challenges:

1. Pre-launch design process
2. Stress testing
3. Use of additional liquidity management tools

European Systemic Risk Board (ESRB) – Recommendation on liquidity and leverage risks in investment funds, April 2018

ESRB recommendations to address systemic risks related to:

1. Liquidity mismatches
2. Use of leverage in investment funds

ESMA publish Final Report on Guidelines on Liquidity Stress Testing in UCITS and AIFs, Sept 2019

Financial Stability Board

In January 2017, the Financial Stability Board (FSB) issued policy recommendations to address structural vulnerabilities from asset management activities.[4] This looked at the following areas:

- Liquidity mismatch between fund investments and redemption terms and conditions for open-ended funds.
- Leverage within investment funds.
- Operational risk and challenges at asset managers in stressed conditions.
- And securities-lending activities of asset managers and funds.

In February 2019, the FSB was again looking at systemic risks, arguing that regulators should pay more attention to risks given the record level of assets under management and the consequent risk posed by a sudden surge in redemptions.[5]

International Organization of Securities Commissions

In February 2018, the International Organization of Securities Commission's (IOSCO's) final report looked at recommendations and good practices to improve liquidity management for investment funds.[6] In this, IOSCO looked at the prelaunch design process, stress testing and the use of additional liquidity management tools.

European Systemic Risk Board

At the end of April in the same year, a set of recommendations were published by the European Systemic Risk Board (ESRB) on liquidity and leverage risks in investment funds.[7] This report also looked at liquidity mismatches and the use of leverage in investment funds.

Global comparisons

In our related articles, we take a deeper dive into liquidity practices and guidelines at international, European, US and Asian levels, but before looking at the details, let's see how they compare or contrast in the following summary.

High-level requirement	**International** IOSCO's Recommendations for Liquidity Risk Management for Collective Investment Schemes Final Report	**Singapore** MAS's Guidelines on Liquidity Risk Management Practices for Fund Management Companies	**Hong Kong** SFC's Consultation Conclusions on Proposals to Enhance Asset Management Regulation and Point-of-Sale Transparency	**US** Rule 22e-4 under the 1940 Act	**Europe** ESMA's Final Report – Guidelines on Liquidity Stress Testing in UCITS and AIFs
Applicable from	**February 2018**	**16 August 2018**	**17 November 2018**	**1 June 2019**	**30 September 2020**
Scope	"Responsible entities" (REs)[8]	Licensed FMCs who hold a capital markets services license for fund management; and Registered FMCs[9]	All SFC-licensed or -registered persons acting as fund managers, including, as appropriate, their representatives[10]	Registered investment companies and ETFs[11]	UCITS and AIFs, including ETFs, leveraged close-ended AIFs and fund depositaries

IOSCO's recommendations		High-level comparisons: Singapore	Hong Kong	US	Europe
Draw up LRMP	1. RE should draw up an effective LRMP, compliant with local jurisdictional liquidity requirements[12]	✓	✓	✓	✓
Thresholds	2. RE should set appropriate liquidity thresholds, proportionate to the redemption obligations and liabilities of the CIS	✓	✓	✓	✓
Dealing frequency	3. RE should carefully determine a suitable dealing frequency for units in the CIS		✓	✓	✓
Process frequency and further considerations	4. RE should ensure that CIS dealing (subscription and redemption) arrangements are appropriate for its investment strategy and underlying assets throughout the entire product lifecycle, starting at the product design phase	✓	✓	✓	✓
	5. RE should consider liquidity aspects related to its proposed distribution channels		✓	✓	
	6. RE should ensure that it will have access to, or can effectively estimate, relevant information for liquidity management		✓	✓	✓
Disclosure to investors	7. RE should ensure that liquidity risk and the LRMP are effectively disclosed to investors and prospective investors	✓	✓	✓	✓
Governance framework	8. RE's LRMP must be supported by strong and effective governance	✓	✓	✓	✓
Maintenance	9. RE should effectively perform and maintain its LRMP	✓	✓	✓	✓
Assessment	10. RE should regularly assess the liquidity of the assets held in the portfolio		✓	✓	✓
Incorporate in investment decisions	11. RE should integrate liquidity management in investment decisions		✓	✓	✓
Identify issues before they arise	12. The LRMP should facilitate the ability of the RE to identify an emerging liquidity shortage before it occurs	✓	✓	✓	✓
	13. RE should be able to incorporate relevant data and factors into its LRMP in order to create a robust and holistic view of the possible risks			✓	✓
	14. RE should conduct ongoing liquidity assessments in different scenarios, which could include fund-level stress testing, in line with regulatory guidance	✓	✓	✓	✓
	15. RE should ensure appropriate records are kept, and relevant disclosures made, relating to the performance of its LRMP		✓	✓	✓
Stress testing	16. The RE should put in place and periodically test contingency plans with an aim to ensure that any applicable liquidity management tools can be used where necessary, and if being activated, can be exercised in a prompt and orderly manner	✓	✓	✓	✓
Additional liquidity measures	17. The RE should consider the implementation of additional liquidity management tools to the extent allowed by local law and regulation, in order to protect investors from unfair treatment, amongst other things, or prevent the CIS from diverging significantly from its investment strategy	✓	✓	✓	✓
Depositary oversight	No specific requirement included in IOSCO Principles				✓

And the winner is...

Regardless of the jurisdiction in which you operate, strong liquidity management processes, including plans for operating under stressed market conditions, is clearly considered key to managing a fund's portfolio and its ability to redeem assets to meet investor redemption requests.

Will regulators ultimately make changes to the existing legislation governing risk management and liquidity stress testing specifically, or will the existing wealth of information and guidance already published suffice?

It is interesting to see where ESMA's Guidelines has finally positioned itself, particularly given the increased focus on liquidity issues that have been evidenced recently. See our European liquidity article for more details.

Most recent regulatory comment

Taking an international perspective, the Bank of England's biannual financial stability report reiterates that this is a global issue.[13]

For that reason, the Financial Policy Committee (FPC) supported the FSB's 2017 recommendation that funds' assets and investment strategies should be consistent with their redemption terms, and further suggested that subsequent work by IOSCO did not prescribe how this should be achieved.

In principle, funds are not permitted to favour one group of investors over another, but there are no prescriptive requirements for how this should be undertaken in practice.

A forthcoming Bank of England and UK FCA review will examine the costs and benefits of aligning redemption terms, including pricing and notice periods, with the typical time it takes to realise market prices for funds' assets in normal and stressed market conditions.[14]

The review will also assess the effectiveness of measures that are already used to deal with misalignment of redemption terms and asset liquidity, such as swing and fair-value pricing and suspensions. The FPC will review progress and provide an update in due course.

In a recent letter from Andrew Bailey, the chief executive of the UK FCA, addressed to The Lord Myners, House of Lords, it suggests considering the US SEC approach, which creates a purposive test, requiring fund managers to allocate assets to liquidity buckets based on the estimated time it would take to sell the asset.[15]

On 7 August 2019, the Central Bank of Ireland issued an Industry Letter regarding the importance of ongoing, effective liquidity management and ensuring compliance with relevant legislation and regulatory obligations for UCITS and AIFs.

The Industry Letter makes it clear that the responsibility of liquidity risk management rests with the board of the fund management company, the individual directors and the relevant designated persons.

There is no requirement for fund management companies to respond to the Industry Letter, but all such companies, and specifically their designees for fund risk management, should undertake a review of their risk management framework to take account of the issues highlighted in the Industry Letter, ESMA's Consultation (since published as final guidelines) and recent market events, particularly with regard to stress testing.

IOSCO responds to FPC

Following earlier comments from the FPC, on 18 July 2019, IOSCO issued a Statement on its Liquidity Risk Management Recommendations for Investment Funds, explaining why, in its opinion, the 2018 LRM Recommendations provided a comprehensive framework for regulators to deal with liquidity risks in investment funds.[16]

In the future

IOSCO's view is that the 2018 LRM Recommendations are directed at preventing liquidity and redemption mismatches from arising in the first place, rather than just mitigating problems as they crystallise. IOSCO also feels that they deal with the attendant benefits and risks when, exceptionally, open-ended funds may look to use other liquidity management tools (such as suspensions and swing pricing) in the face of increasing redemption pressures. This includes the need to treat investors fairly and to consider any broader market implications.

IOSCO intends to conduct a robust assessment exercise beginning in 2020, which will review how the 2018 LRM Recommendations have been implemented in practice.

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1 In associated articles in this edition, we also take a more in-depth look at specific liquidity requirements at an international level in Europe, Hong Kong, Singapore and the US.

2 From "Mark Carney Says Illiquid Investment Funds Are 'Systemic' Threat as Neil Woodford Bags £135m Windfall" at www.telegraph.co.uk. Link Here.

3 Search Financial Stability Report, May 2019, at www.federalreserve.gov. Link Here.

4 Search Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities at www.fsb.org. Link Here.

5 Search FSB Publishes Global Monitoring Report on Non-Bank Financial Intermediation 2018 at www.fsb.org. Link Here.

6 Search Recommendations for Liquidity Risk Management for Collective Investment Schemes at www.iosco.org. Link Here.

7 Search ESRB 2017 6 at www.esrb.europa.eu. Link Here.

8 REs are those responsible for the overall operation of a collective investment scheme (CIS) and in particular its compliance with legal or regulatory framework in the respective jurisdiction.

9 Licensed FMCs that hold a capital markets services license for fund management; Registered FMCs registered under paragraph 5(1)(i) of the Second Schedule to the Securities and Futures (Licensing and Conduct of Business) Regulations (Rg.10) applicable to FMCs that manage ETFs; Recognised CIS; and close-ended CIS and CIS with lock-up periods.

10 All SFC licensed or registered persons acting as Fund Managers, including as appropriate, their representatives.

For liquidity management requirements specifically: paragraphs 3.14.1 to 3.14.3 (inclusive) of sub-section 3.14.1, except for 3.14.1(b) and 3.14.1(c) are only applicable to a Fund Manager that is responsible for the overall operation of a fund.

11 MMFs are subject to separate, more stringent, liquidity requirements.

12 Liquidity risk management process (LRMP).

13 Search Financial Stability Report and Record, July 2019, at www.bankofengland.co.uk. Link Here.

14 Specific timing is not provided in the report.

15 Re: Review of the Case for the UK Establishing Its Own Requirements for liquidity Standards for Undertaking for Collective Investment in Transferable Securities, available at www.fca.org.uk. Link Here.

16 Liquidity Risk Management Recommendations (LRM Recommendations) of February 2018 (2018 LRM Recommendations).

CONTACTS

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