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المنظمة الدولية لهيئات الأوراق المالية

STATEMENT ON IOSCO LIQUIDITY RISK MANAGEMENT RECOMMENDATIONS FOR INVESTMENT FUNDS
18 July 2019

Liquidity problems which have recently affected some investment funds have been the subject of extensive media coverage. The Bank of England published a Financial Stability Report of the Financial Policy Committee (FPC), a committee of the Bank of England, earlier this month, which discusses potential mismatches between the liquidity of fund assets and redemption terms offered by funds to their investors. These developments have led some to question whether recommendations previously issued by the International Organization of Securities Commissions (IOSCO) on the liquidity management of open-ended investment funds (OEFs) adequately address risks in OEFs which could disadvantage investors or lead to broader financial system contagion.

In particular the FPC has stated that “This is a global issue. For that reason, the FPC supported the Financial Stability Board’s 2017 recommendation that funds’ assets and investment strategies should be consistent with their redemption terms. However, subsequent work by IOSCO did not prescribe how this should be achieved.”

IOSCO issued its Liquidity Risk Management Recommendations in February 2018 (2018 LRM Recommendations) following an extensive public consultation exercise. **This statement explains why these recommendations do, in fact, provide a comprehensive framework for regulators to deal with liquidity risks in investment funds, as explained below.**

Suspension of fund investors’ ability to redeem for cash

There have been some recent high-profile instances where OEF managers have decided to suspend or “gate” investor redemptions. Suspensions may follow a determination by an OEF manager that the fund is unable to sell a sufficient quantity of underlying assets, or sell enough assets at acceptable prices, to meet current or anticipated redemption demands from investors or to meet those demands on a fair basis. The concern is that when an OEF has committed a large proportion of its portfolio to relatively illiquid assets (possibly in a “reach for yield”), existing promises to investors that they can redeem their investments for cash very quickly – even on a daily basis – become inherently unreliable.

Against this background it is reasonable to ask whether the 2018 LRM Recommendations provide sufficient guidance to enable funds and regulators to achieve an appropriate alignment between funds' assets and their investment strategies, whether they leave too much discretion to national regulators leading to differences of approach between jurisdictions, or whether they give too much leeway to fund managers to resort to suspensions or gating of redemptions rather than properly aligning liquidity and redemption terms in the first place.

IOSCO recommendations stress a proper alignment of fund assets and redemption terms

The 2018 LRM Recommendations are unequivocal that, *throughout the entire lifecycle of the fund* (design, pre-launch, launch and subsequent operations), there should be an *appropriate alignment between portfolio assets and redemption terms*. In particular, the recommendations make clear that OEFs should *not* be managed in such a way that the investment strategy *relies* on any additional ex-post measures such as suspensions. These measures are not a substitute for sound liquidity risk management from the outset, so that the dealing frequency of units meets the anticipated liquidity needs of the fund under normal and foreseeable stressed market conditions.

Annex 1 refers to some of the 2018 LRM Recommendations which address these expectations. They cover, among other matters, the need to ensure that OEFs with daily redemptions should have stricter liquidity requirements than those with longer- term redemptions and that OEFs invested in real estate (or other illiquid assets) with more frequent redemptions should hold a stock of relatively more liquid assets.

The 2018 LRM Recommendations make clear, however, that ex-post liquidity management measures such as suspension and swing pricing are important and necessary components of a comprehensive OEF risk management toolbox that should be available for use in exceptional circumstances. Use of these measures might also alleviate selling pressure in the underlying asset class when markets are severely stressed. It would be unrealistic to expect that fund managers will be able to match a fund's liquidity with dealing periods at all times and in all circumstances, no matter how extreme, so as to eliminate any possibility of needing to suspend redemptions.

Principles-based or prescriptive global standards for fund liquidity?

It would be impractical to pursue, as some have suggested, a *global* "one size fits all" prescriptive approach which tries to match different asset classes, fund investment strategies and redemption periods according to universally applicable standards. This is because the fund management industry (compared to, for example, the banking sector) is extremely diverse. Funds employ a multitude of different investment strategies and encounter varying degrees of liquidity amongst a huge variety of investable asset classes and as between jurisdictions. Liquidity within one asset class can change over time in response to external factors affecting that class. Funds target different types of investors, the sizes of individual funds also vary relative to the markets in which they invest and funds differ in the ways in which they are distributed across global markets.

The 2018 LRM Recommendations do, however, contain practical, actionable principles which support those domestic regulators who may wish or need to pursue a prescriptive approach responsive to the nature of particular OEFs they supervise directly and/or specific characteristics of the local markets in which they operate. Domestic regulators may also need to address related conduct concerns, such as those which may arise from the way in which individual funds are managed or marketed, including material disparities between legitimate investor expectations of liquidity (as per a fund's disclosure materials or regulatory classification) and the reality.

Conclusion and next steps

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. And they deal with attendant benefits and risks when OEFs may exceptionally look to use other liquidity management tools (such as suspensions and swing pricing) in the face of untoward redemption pressures, including the need to treat investors fairly and to consider any broader market implications. They also allow domestic regulators to apply the recommendations in a prescriptive manner to manage specific or idiosyncratic liquidity risks.

Securities regulators are, however, expected to ensure effective implementation of the 2018 LRM Recommendations. Some domestic regulators have adopted, or are consulting on, liquidity management regimes consistent with the recommendations. IOSCO intends to conduct a robust assessment exercise beginning in 2020 which will review how the 2018 LRM Recommendations have been implemented in practice.

Ashley Alder
IOSCO Board Chair

Annex 1

Specific 2018 LRM Recommendations:

- Responsible entities shall integrate liquidity management in investment decisions, notably the impact of an investment on the overall liquidity of a fund so as to only carry out transactions which do not compromise the ability of a fund to meet its liabilities in terms of liquidity;[1]
- Responsible entities are expected to
    - draw up effective liquidity risk management processes,[2]
    - effectively estimate and manage liquidity risk in a fund,[3]
    - regularly assess the liquidity of the assets held in the portfolio, considering obligations to creditors, counterparties, other third parties,[4]
    - identify an emerging liquidity shortage before it occurs, thus enabling them to take appropriate actions in anticipation, including via fund level stress testing;[5]
- They should set appropriate liquidity thresholds which are proportionate to the redemption obligation and liabilities of the CIS, in line with the fair treatment of investors and the CIS investment strategy;[6]
    - CIS with daily redemption are expected to have stricter liquidity requirements than CIS operating with longer-term redemptions;
    - CIS invested in, for example, real estate with more frequent redemptions may be expected to hold a stock of relatively more liquid assets;
- They shall ensure that liquidity risk and liquidity risk management processes are effectively disclosed to investors and prospective investors;[7]
- Securities regulators should, at the time of authorisation and on an on-going basis, consider the inter-relationship between the asset types, the dealing and notice arrangements and the disclosure arrangements.

[1] Recommendation 11
[2] Recommendations 1, 8, and 9.
[3] Recommendations 4, 5, and 6.
[4] Recommendation 10.
[5] Recommendations 12, 14, and 16.
[6] Recommendations 2 and 4.
[7] Recommendation 7.