FSB Consultation on Liquidity Mismatch in Open-Ended Funds

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FSB

Assessment of the effectiveness of the FSB's 2017 Recommendations on liquidity mismatch in OEFs

- In 2022, the FSB assessed the effectiveness of its 2017 Policy recommendations to address structural vulnerabilities from asset management activities in relation to liquidity mismatch in OEFs
  - Assessment took place in parallel with IOSCO's review of the implementation of its Recommendations for Liquidity Risk Management for OEFs
- The assessment concluded that the FSB Recommendations remain broadly appropriate, but that enhancing clarity and specificity on the policy outcomes they seek to achieve would make them more effective from a financial stability perspective
- The FSB and IOSCO are carrying out follow-up work based on assessment findings
  - This work forms part of the FSB's work programme to enhance the resilience of non-bank financial intermediation (NBFI)

Overall objectives of the revised Recommendations

- Follow up on the findings of the 2022 FSB assessment report by enhancing clarity and specificity on the policy outcomes that the FSB Recommendations seek to achieve
- The revised Recommendations are addressed to financial regulatory and supervisory authorities and set out the key objectives for an effective regulatory and supervisory framework to address vulnerabilities arising from liquidity mismatch in OEFs
- The revised Recommendations, combined with the new IOSCO guidance on anti-dilution liquidity management tools (LMTs), aim to achieve a significant strengthening of liquidity management by OEF managers compared to current practices

Recommendation 3: Structural liquidity mismatch in OEFs

- The revised text provides greater clarity on the redemption terms that OEFs could offer to investors, based on the liquidity of their asset holdings
- Authorities should have requirements or guidance on funds' liquidity risk management which should state that funds' investment strategies and the liquidity of their assets in normal and stressed market conditions should be consistent with redemptions terms and conditions, both at the time of designing a fund and on an ongoing basis
- OEFs would be grouped into different categories depending on the liquidity of their assets. This would be based on factors including market depth and turnover, days to trade, the efficiency and effectiveness of the pricing mechanism, the price impact of large transactions, operational features and potential frictions, and valuation certainty
- OEFs would be subject to specific expectations in terms of their redemption terms and conditions

Recommendation 3 (cont'd): The bucketing approach

- For OEFs that invest mainly (i.e. more than 50%) in *liquid* assets daily dealing would remain appropriate, with continued enhancement of liquidity management practices, e.g. implementing anti-dilution LMTs as per Recommendation 5
- For OEFs that invest mainly in *less liquid* assets offering daily dealing to investors (without notice or settlement periods) may remain appropriate, subject to OEF managers being able to demonstrate to the authorities that they implement anti-dilution LMTs in line with the revised Recommendations. Otherwise, OEFs should consider and use measures to reduce the liquidity offered to fund investors (e.g. by reducing redemption frequency and/or by implementing long notice or settlement periods)
- OEFs that allocate a significant proportion (i.e. 30% or more) of their assets under management (AUM) to *illiquid* assets should create and redeem shares at lower frequency than daily and/or require long notice or settlement periods
- Funds that do not clearly fall into (only) one of the three main categories, the OEF manager should adopt a prudent approach in determining the category to which the fund should be classified

Related consultation questions

We are consulting on the following issues

- In order to facilitate the application of the bucketing approach, how would you further describe "normal" and "stressed" market conditions?
- What factors should be considered in determining whether assets are liquid, less liquid or illiquid?
- Is the use of specific thresholds an appropriate way to implement the bucketing approach? If yes, which thresholds would be more appropriate and why?
- For OEFs investing in less liquid assets that do not meet the expectation on the implementation of anti-dilution LMTs, what type of adjustment to redemptions terms and conditions should the FSB consider recommending?

Recommendations 4, 5 and 8: Liquidity management tools

- The revisions aim at achieving greater inclusion of anti-dilution LMTs in OEF constitutional documents and greater use of, and greater consistency in the use of, anti-dilution LMTs in both normal and stressed market conditions
- These anti-dilution LMTs would reduce first mover advantage by imposing on redeeming and subscribing investors the explicit and implicit costs of redemptions and subscriptions, including any significant market impact of asset sales and purchases to meet those redemptions and subscriptions
- Authorities should ensure the availability of a broad set of anti-dilution as well as quantity-based LMTs for use by OEF managers in normal and stressed market conditions. The latter include suspensions, redemption gates, in-kind redemptions and side pockets, that are to be used particularly in stressed market conditions

Recommendations 4, 5 and 8 (cont'd)

- OEF managers should have appropriate internal systems, procedures and controls in place that enable the use of anti-dilution LMTs as part of the day-today liquidity risk management of the OEFs they manage, even if such tools would not always be in use
- These revised recommendations in particular should be read in conjunction with the IOSCO consultation report on guidance on anti-dilution LMTs

Related consultation questions

We are consulting on the following issues

- Do the proposed changes help achieve greater use and a more consistent approach to the use of anti-dilution LMTs?
- Are there any obstacles to the implementation of the revised FSB Recommendations on the use of anti-dilution LMTs?
- Would additional guidance on OEF internal systems, procedures and controls enabling mangers to use anti-dilution LMTs be useful?
- Do you agree with applying anti-dilution LMTs to subscribing investors as well?
- Would additional international guidance on the availability and use of quantity-based LMTs be useful?
- 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?

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