Report on the Evaluation of the Effectiveness of the 2017 FSB Recommendations on the Management of the Liquidity Mismatch of Open Funds

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In 2017, the Financial Stability Board ("FSB") published Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities ("FSB Recommendations"), which included liquidity mismatches in open funds ("Open Ended Funds" or "OEF").Taking most of these recommendations into consideration, IOSCO issued in 2018 the Recommendations for Liquidity Risk Management for Collective Investment Schemes.The Report **Assessment of the Effectiveness of the FSB´s 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds** (the "Report") published on December 14, 2022, is part of its work plan to assess the resilience of the non-financial intermediation sector. This report has been carried out at the same time as IOSCO's review of its 2018 recommendations and analyses the implementation and effectiveness of the recommendations issued by the FSB in 2017.
Section 2 of the Report describes the analytical approach used in the exercise. Sections 3 to 6 group the Recommendations into four areas (reducing structural liquidity mismatch; reducing shock amplification and transmission through the use of liquidity management tools; enhancing regulatory reporting, data availability and disclosure; and ensuring adequacy of stress testing) and describe their implementation status and the results of the analysis of its effectiveness. Building on the findings, Section 7 presents a set of policy implications, while Section 8 concludes with the next steps for the FSB and IOSCO to enhance the existing international recommendations and related guidance to address liquidity mismatch in OEFs.

In the 2017 Recommendations Report, the FSB pointed out, among other aspects, that a structural vulnerability of the OEFs is the potential mismatch between the liquidity of the funds' assets and the frequency of liquidity offered to investors. These funds offer short-term liquidity (often on a daily basis), so if market conditions for the fund's assets deteriorate, some investors may request to redeem their holdings, thus giving them an advantage in relation to the investors who remain in the fund, who would have to bear the cost associated with the sale of assets to meet redemptions. To the extent that there are no appropriate liquidity management tools that eliminate these expectations, a first-mover advantage may give rise to an increase in the redemptions, especially in stressed market conditions. Funds´ sale of portfolio assets to meet such repayments may result in greater market volatility, which could result in negative spillovers.To address these vulnerabilities, the FSB issued the 2017 Recommendations which sought to strengthen regulatory reporting to facilitate assessment of liquidity risk in OEFs; promote liquidity management, both at the fund design phase and on an ongoing basis; increase the availability and use of liquidity management tools, in normal situations and in times of stress in the markets; and incentivise fund-level and system-wide stress testing.

Main findings

The analysis carried out indicates that, although there has been significant progress in the implementation of the 2017 FSB recommendations, lessons learned since their publication, including during the March 2020 market turmoil, suggest that improvements are needed in terms of the clarity and specificity of the objectives that are sought to increase their effectiveness from a financial stability perspective.

Reducing structural liquidity mismatch

Although many jurisdictions have implemented regulatory measures regarding, on the one hand, the consistency between fund assets and investment strategies, and, on the other, redemption terms and conditions, there are still differences regarding the levels of specificity in such measures across jurisdictions. In terms of reducing structural liquidity mismatches, the report notes that no significant reduction has been observed since the Recommendations were issued, which could have a potential impact on the vulnerability of the OEF sector, which has grown in

absolute terms.

Reducing shock amplification and transmission through the use of Liquidity Management Tools

Many jurisdictions allow OEF managers to use a wide range of Liquidity Management Tools ("LMT") and available information indicates that there has been a gradual increase in their inclusion in the funds constitutional documents since the recommendations were published. The use of LMT increased mainly during episodes of market stress caused by the COVID-19 turmoil and the rise in redemption requests, especially from corporate bond funds. However, the available data point to material differences in terms of the factors considered by corporate bond funds that use variable prices in calculating net asset value ("swing pricing").It is indicated that it is still possible to make progress in the implementation of tools, especially anti-dilutive ones, which pass the cost of liquidity to investors who request redemption, both in normal situations and in times of market stress. Likewise, it is noted that, even if there are LMT available, there may be factors such as costs, reputational or competitive risks, which could discourage their use by fund managers or their inclusion in the fund's constitutional documents.

Enhancing regulatory reporting, data availability and public disclosure

Although progress has been made in improving regulatory reporting and data availability, the report indicates that there are differences in the scope, frequency, and content of periodic reporting and that some jurisdictions may collect data more frequently when necessary for tasks supervision. Although this data is useful in stress situations, it may not be suitable for an ex-ante assessment of vulnerabilities. Difficulties are also observed by the FSB to obtain and analyse data that allow evaluating the effectiveness of its recommendations. It is pointed out that there are still challenges for the authorities, in terms of measuring and monitoring the liquidity mismatch, as well as the availability, use and effectiveness of LMT for assessing vulnerabilities of OEFs.Although all the jurisdictions surveyed require disclosure of fund liquidity risk to investors, it is suggested that improvements can be made in this area. Likewise, it is pointed out that all market participants consider that it is important to ensure that there is sufficient information on the availability and use of LMT by OEFs so that investors can take it into account in their investment decisions.

Adequacy of stress testing

Most of the jurisdictions surveyed require fund managers to conduct ongoing liquidity assessments at fund level, under different scenarios. Additionally, others carry out more extensive stress testing, in order to capture the effect of the sale of assets on the resilience of financial markets and the financial system more generally.

Policy implications and next steps

Based on this assessment, it is concluded that it is necessary to carry out improvements in the recommendations, as well as develop guidelines on liquidity management practices in OEFs. Both the FSB and IOSCO have proposed to carry out follow-up work based on the findings of the evaluation of their respective recommendations. These workstreams refer to the revision of the FSB and IOSCO Recommendations in order to address structural liquidity mismatch and promote the use of LMT, as well as to clarify the role of fund managers and regulators in implementing the recommendations; development of guidelines on the design and use of LMT; work to enhance the availability of OEF-related data for financial stability monitoring purposes; and the necessary steps to promote the use of stress testing. As part of this process, a public consultation on the revision of the Recommendations will take place and new guidance will be issued.Firstly, it is pointed out that a clear and specific definition of the intended outcome of policies to reduce structural liquidity mismatch in OEFs would strengthen the effectiveness of the Recommendations. In particular, FSB Recommendation 3 should be revised as it relates to the redemptions that OEFs offer to investors, based on the liquidity of the portfolio assets. Thus, funds with a significant proportion of illiquid assets in normal conditions (for example, between 30-50% or more of their portfolio), should not offer daily liquidity to investors and/or require long notice or settlement periods. Funds mainly holding less liquid assets, or assets that are vulnerable to situations of liquidity stress in the markets, may offer daily liquidity as long as they can apply anti-dilutive LMT that pass on implicit and explicit redemption costs to investors who request to redeem their shares. Alternatively, such funds may apply measures such as reducing the redemption frequency or establishing long notice or settlement periods.

Secondly, it is observed that it is possible to strengthen the LMT framework globally and reduce the first-mover advantage to ensure that investors bear the costs of liquidity associated with subscriptions and redemptions, moving towards a consistent approach to the use of LMT by fund managers. It is proposed to strengthen Recommendations 4, 5 and 8 so that said anti-dilutive LMT are included in the funds´ constitutional documents; its use is generalized, both in normal and stress market conditions; and investors are aware of the objectives and

operation of anti-dilutive LMT. As a complement to the above, the FSB recommends that authorities require public information from fund managers on the LMT of each fund and on its use under normal and stress conditions.

Thirdly, the need to improve the collection of data for the authorities to monitor liquidity mismatch and its management for the purposes of financial stability is pointed out. For this reason, it is proposed to carry out a voluntary pilot program among FSB member jurisdictions to examine how to improve data availability, including the cost and effort needed to expand information reporting obligations, prioritising data gaps to close in order to improve central banks and securities regulators´ ability to monitor vulnerabilities of OEFs related to liquidity mismatch.

Finally, the FSB will consider further promoting the use of fund- and system-level stress testing as well as sharing of experiences on the design and use of such tests.

The FSB and IOSCO will monitor the progress of the different jurisdictions in implementing the Recommendations, and, once they are widely implemented, an evaluation of the effectiveness of the policies to address the risks of the OEF liquidity mismatches.

Useful links: FSB publishes Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities - Financial Stability Board FR01/2018 Recommendations for Liquidity Risk Management for Collective Investment Schemes (iosco.org) Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds