

Liquidity Risk Management

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1. Introduction

The handling of liquidity risks in open-ended investment funds, particularly in the case of retail investors, is once again in the headlines. The European Securities and Markets Authority (ESMA) announced that, following on from its review of liquidity in UCITS products, it has identified “scope for improvement in liquidity management”¹. This follows on from a number of headline grabbing failures in this space over the last few years, including the Woodford funds² and UK commercial property funds post the Brexit referendum in 2016³.

Liquidity risk management has always been a major area of focus in the alternative investment industry and is extensively covered by the SBAI’s Alternative Investment Standards (Standards). As early as 2009, the SBAI held a special consultation to improve the Standards to address concerns about the handling of redemptions in times of liquidity distress. The Open Protocol risk reporting framework, hosted by the SBAI, provides a valuable tool for both asset managers and allocators to understand their risk exposures – including liquidity risk.

What do the Standards Say - Handling of Redemptions in Situations of Liquidity Distress

As a general principle, redemptions should be honoured if fair treatment of investors can be ensured. In normal conditions, liquidity risk management should ensure the liquidity of the portfolio matches with the redemption terms specified in the fund’s governing documents. In periods of stress, however, market liquidity can evaporate and this, combined with significant investor redemptions, can lead to situations where non-redeeming investors fear an increase in the concentration of their illiquid exposure if redemption requests are satisfied from sale proceeds of liquid assets in the portfolio. This can result in a “rush to the exit” from all investors, creating a classic “prisoners’ dilemma”, with no incentive for investors to remain in the fund.

There are a range of liquidity management tools that can be used to mitigate this risk and the Standards provide guidance on how these tools can be used in an effective and appropriate way. All these measures help improve investor trust and prevent unfair treatment of investors in times of distress, therefore reducing the risk of runs on funds.

Redemption Management Tools:

These are tools that can be used to suspend or slow the redemption process, for example side-pocketing or gating. They are used in times of market distress and are typically used at the discretion of the fund’s

¹ ESMA Results of the 2020 Common Supervisory Action (CSA): <https://www.esma.europa.eu/press-news/esma-news/esma-assesses-compliance-ucits-liquidity-rules-and-highlights-areas-vigilance>

² <https://www.ftadviser.com/investments/2019/12/09/watchdog-investigates-funds-with-woodford-holdings/>

³ <https://www.fitchratings.com/research/fund-asset-managers/uk-property-fund-re-openings-hinge-on-liquidity-levels-10-09-2020>

governing body. Gating refers to the practice of limiting the percentage of the portfolio that can be redeemed at each valuation point and side pockets can be used to segregate the illiquid assets in a portfolio from the liquid ones.

Standard 2.1: The commercial terms applicable to the relevant interests being offered in a particular fund should be disclosed in the fund's offering documents in sufficient detail and with sufficient prominence (taking into account the identity and sophistication of potential investors).

Guidance to Standards: *Disclosure of Exit Terms (in the case of open-ended funds):*

- *The period of notice investors are required to give to redeem their investment in the fund,*
- *The circumstances in which redemption requests can be revoked (e.g., redemption requests may be irrevocable except with consent of the fund governing body),*
- *Details of any redemption penalties (including, if relevant, any fee or penalty applicable where redemption requests are revoked),*
- *Details of any "lock-up" periods during which the investor will be unable to redeem its investment in the fund and any limits on the extent of redemptions on any redemption date (i.e., redemption "gates"), and*
- *An indication of circumstances in which normal redemption mechanics might not apply or may be suspended, if any – these could include, amongst other things:*
 - *A significant reduction in the liquidity of the fund's underlying assets, and*
 - *Distress of one or more of the fund's counterparties (including its prime broker(s)) leading to uncertainty as to the value of OTC contracts or access to / ownership of rehypothecated assets.*

Approach to Liquidity Risk Management:

A solid approach to liquidity risk management will include considering the handling of redemptions and stress testing of the portfolio.

Standard 11.1: A fund manager should ensure that adequate risk management processes and resources are available and well understood by portfolio managers, traders, risk managers, senior staff and other staff related to the management of the portfolio. A fund manager should also discuss these risk management processes with the fund governing body and do what it reasonably can to assist the members of the fund governing body to understand such processes.

Standard 12.1: A fund manager should develop a liquidity management framework, the primary role of which is to limit the risk that the liquidity profile of the fund's investments does not align with the fund's obligations.

Standard 12.2: A fund manager should regularly conduct stress testing and scenario analysis of the fund's liquidity position.

Governance and Oversight Arrangements:

Asset managers should ensure there are robust governance and oversight approaches in place that are designed to protect the investors in the fund. These governance process should also be disclosed to investors.

Standard 21.6: Careful consideration should be given to the extent to which the adoption by the fund governing body of all or parts of established codes of corporate governance or other director guidance is appropriate. Fund governing bodies should be adequately resourced in order to comply with any such corporate governance code or director guidance. This includes ensuring that the fund governing body has adequate resources to comply with any such corporate governance code or director guidance.

The [SBAI's Standardised Board Agenda](#) details the following related items that should be discussed in each board meeting:

- Portfolio liquidity profile analysed against investor liquidity,
- Liquidity analysis: fund's liquidity profile, and
- Review of current and pending subscriptions and redemptions.

Where liquidity management tools such as gates or side pockets are to be enacted, these should also be formally ratified in the board meeting (following on from the board consent that may have been obtained at an earlier point in time).

Funds for Institutional Investors:

Institutional alternative investment funds often have longer notice periods for redemptions or longer lock-up periods compared to retail funds, this significantly reduces the risk of a run on the fund by providing more time for the asset manager to unwind positions in an orderly manner. Some funds may also be structured as closed-ended vehicles, where investors cannot redeem until underlying assets have been sold (for example, private equity and certain types of alternative credit funds). The SBAI's Alternative Credit Working Group has published a [Toolbox Memo on Choice of Fund Structures](#) and the [SBAI's ILS Working Group](#) is currently exploring the topic of Side-Pocketing in ILS Funds.

Open Protocol – Enabling Better Understanding of Liquidity Risks

ESMA's review is a timely reminder for all investors to monitor their liquidity risks, both for individual funds and the aggregate portfolio. Open Protocol, a comprehensive risk reporting framework (available through the [SBAI Toolbox](#)), covers exposure information from many different investment strategies and provides detailed metrics which facilitate the assessment of the risk profile (including liquidity) of the fund for each exposure type:

- Equity Exposures: market capital exposure and instrument liquidity.
- Sovereign & Interest Rate Exposures: instrument liquidity.
- Credit and Convertible Bond Exposures: instrument liquidity and concentration of ownership
- Real Assets & Commodities Exposures: instrument liquidity

Open Protocol also provides detailed information about investor liquidity – the percentage of assets that can be redeemed by investors in different time intervals - and unencumbered cash.

The SBAI encourages managers and investors to review and adopt Open Protocol to improve overall risk management. Systemic risk supervisors are also encouraged to review or adopt the Open Protocol methodology in their own efforts to better understand potential financial stability concerns.

More information about OP is available [here](#).