FSC Newsletter

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Financial Services Commission

IOSCO Principles of Liquidity Risk Management for CIS

Introduction

The International Organisation of Securities Commissions (IOSCO) is an international body which includes the world's securities regulators and is acknowledged as an organisation which globally sets standards for the securities sector. From time to time, IOSCO develops principles, setting out good practices, which serve as a guidance to regulators and firms. This promotes adherence to internationally recognised standards for securities regulation and as a result, enhances investor protection.

Thus, it is recommended, that securities regulators and firms comply with these principles and promote investor confidence in the securities markets.

The Financial Services Commission (FSC), as a member of IOSCO, is required to meet its core obligations by complying with these standards and taking forward the changes suggested by the organisation.

This Newsletter outlines the 15 principles on liquidity risk management for Collective Investment Schemes, as issued by IOSCO.

Background

The Technical Committee of IOSCO published 15 principles on Liquidity Risk Management for Collective Investment Schemes (CIS). Generally, these principles aim to reflect a common approach and be a practical guide for regulators and industry practitioners.

The topic of liquidity has been a key concern in the current global process of regulatory reform, although discussions have tended to focus on the importance of liquidity in banking, rather than other sectors. Despite the fact that liquidity crises are less likely to cause systemic confidence problems in funds, as are experienced in banking, a fund may still experience liquidity problems.

Liquidity risk management in CIS is a complex area as poor liquidity can arise from many different sources, some of which are outside the control of the entity operating or managing the CIS.

Liquidity risk management in CIS is directly linked to other aspects of the CIS operation – in particular valuation. Hence effective liquidity risk management requires effective and robust valuation arrangements.

In exceptional circumstances, a liquidity problem could lead to a CIS temporarily suspending all investor redemptions. The FSC has issued a Newsletter based on the IOSCO *Principles on Suspension of CIS Redemptions*, which sets out areas of good practice to be observed in this field.

Fundamental requirements of liquidity risk management are to ensure that the degree of liquidity of the open-ended CIS allows it to meet redemption obligations and other liabilities. As such the IOSCO principles, as set out in this Newsletter, provide more detail on how compliance with this requirement can be achieved.

As noted above, liquidity risk management is a particular concern for “open-ended” CIS. However, even for “closed-ended” CIS, some of the material in the principles is relevant; for example, such CIS may need to meet margin calls or other cash commitments to counterparties on a timely basis. Responsible entities for closed-ended CIS are expected to therefore also consider which principles are relevant to them.

The principles are structured according to the three main stages of any relevant process: its establishment; performance/implementation and maintenance; and ongoing review (of its effectiveness).

This Newsletter focuses on the ‘responsible entity’ which should be taken as the Board of the fund. When the fund is not set up as a company, the ‘responsible entity’ will be, for example in the case of an Experienced Investor Fund (EIF), those responsible for managing and controlling a fund, as per Regulation 7 of the Financial Services (Experienced Investor Funds) Regulations for EIFs.

For funds whose managers are under the scope of the Alternative Investment Fund Managers Directive (AIFMD), if there is an overlap, the relevant AIFMD requirements ought to be observed.

Pre-launch Liquidity Risk Management Principles

Principle 1

The responsible entity should draw up an effective liquidity risk management process, compliant with local jurisdictional liquidity requirements

The liquidity risk management process, and its operation, is the fundamental basis of liquidity control within the CIS. The remainder of the principles in this section expands on some of the factors that are to be taken into account as part of this process. The liquidity risk management process forms one part of the broader total risk management process. Risk management generally relies on strong and effective governance.

The liquidity risk management process, while proportionate, needs to be able to be effective in varied market conditions. Where the CIS is likely to be at a greater risk of liquidity problems, the responsible entity is recommended to construct (and perform) a more rigorous liquidity risk management process. Examples of CIS in this category include, but are not limited to, those with a high proportion of illiquid assets and/or a narrow investor base.

The responsible entity is supposed to fully consider the liquidity of the types of instruments in which the CIS’s assets will be invested, at an appropriate level of granularity, and ought to seek to ensure that, taking account of the CIS’s portfolio as a whole, these are consistent with the CIS’s ability to comply with its redemption obligations or other liabilities.

A responsible entity does not need to construct a new process for each new CIS if it already operates a CIS with similar characteristics. However, it is required to ensure the process remains appropriate and relevant and sufficiently bespoke for any other CIS it is used for.

Principle 2

The responsible entity should set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the CIS

IOSCO expects the responsible entity to set appropriate internal definitions and thresholds for the CIS’s liquidity, which are in line with the principle of fair treatment of investors and the CIS’s investment strategy. The thresholds are implemented to act as a signal to the responsible entity to carry out more extensive in-depth, quantitative and/or qualitative liquidity analysis as part of the risk management process (with the intention that the responsible entity would then take appropriate remedial steps if the analysis revealed vulnerabilities).

For example, a daily dealing CIS would be expected to have stricter liquidity requirements than a CIS sold on the basis that investors would not be expected to redeem before a set period expired. Alternatively a CIS that invested predominantly in real estate but promised frequent redemption rights to its investors might consider it appropriate to hold a relatively large stock of more liquid assets (which could be related to real estate) as well, because of the expected length of time it would take to dispose of physical properties in order to meet redemption requests.

The responsible entity is reminded that investor redemptions are not the only source of liquidity demand on a CIS (for example, margin calls from derivative counterparties).

Principle 3

The responsible entity should carefully determine a suitable dealing frequency for units in the CIS

The responsible entity is recommended to ensure that they set a dealing frequency for units in the CIS which is realistic and appropriate for its investment objectives and approach, taking account of its liquidity risk management process, and allowing redemptions to be processed effectively.

The ability to gain certain tax treatment for a CIS, or to access a wider market for distribution, ought to not lead responsible entities to set a more frequent dealing frequency for units in the CIS than is appropriate.

Principle 4

Where permissible and appropriate for a particular CIS, and in the interests of investors, the responsible entity should include in the CIS's constitutional documents the ability to use specific tools or exceptional measures which could affect redemption rights

Certain tools can be used as part of a CIS's "normal" operations, provided there is full disclosure (see principle 7 below), but their inclusion in the constitutional documents does not excuse the responsible entity from needing to consider the remainder of these principles for its liquidity risk management process to be effective.

IOSCO suggests that the responsible entity consider the appropriateness of tools and exceptional measures for their CIS, taking into account the nature of assets held by the CIS and its investor base.

Tools and exceptional measures are to only be used where fair treatment of investors is not compromised, and where permitted by the laws applicable to the CIS. This would apply to for example: exit charges, limited redemption restrictions, gates, dilution levies, in specie transfers, lock-up periods, side letters which limit redemption rights or notice periods. Some of these tools (e.g. notice periods) may be built-in to the CIS's dealing policy, but others may be contingent (e.g. a limit to redemptions met the same day only if redemption requests exceed a certain percentage of the NAV).

Exceptional measures include side pockets or suspensions. CIS's are not supposed to be managed in such a way that the investment strategy relies on the availability of these measures, if liquidity problems be experienced.

Principle 5

The responsible entity should consider liquidity aspects related to its proposed distribution channels

The responsible entity is expected to consider how the planned marketing and distribution of the CIS are likely to affect its liquidity. This ought to also include consideration of market conditions when forecasting their expectations for the volume, type and distribution of investors, as well as the effectiveness of individual distribution channels.

For example where investors hold their investments through aggregated nominee accounts, making it more difficult for the responsible entity to be fully aware of the make-up of the underlying investor base (for example, a holding of one million units in an aggregated account could represent a small number of investors each with large individual holdings, or many more investors each with a smaller number of units). In this situation, a responsible entity is suggested to take all reasonable steps to obtain investor concentration information from nominees to assist its liquidity management (for example, via contractual arrangements).

Principle 6

The responsible entity should ensure that it will have access to, or can effectively estimate, relevant information for liquidity management

The responsible entity is recommended to consider its information needs in order to effectively manage liquidity risk in the CIS, and whether it will be able to access that information during the life of the CIS. For example, where the CIS plans to invest in other CIS the responsible entity ought to be satisfied that it can obtain information about the underlying CISs' approaches to liquidity management and any other pertinent factors such as potential redemption restrictions used by the underlying CISs.

Principle 7

The responsible entity should ensure that liquidity risk and its liquidity risk management process are effectively disclosed to prospective investors

As part of the disclosures in a CIS's offering documents about the risks involved in investing in the CIS, there is supposed to be a proportionate and appropriate explanation of liquidity risk. This can include an explanation of why and in what circumstances it might crystallise; its significance and potential impact on the CIS and its unit-holders, and a summary of the process by which the responsible entity aims to mitigate the risk. For example, disclosure of what actions the responsible entity would take in the event of a liquidity problem would be useful information. The explanation is expected to set out clearly how the investor could be affected.

Explanation of any tools or exceptional measures that could affect redemption rights (see principle 4 above) is to be included in the CIS's offering documents. The explanation is suggested to include what the tool or measure is what effect its use will have on CIS liquidity/investor redemption rights and examples of when the tool or measure might be applied (if it is of a contingent nature). A responsible entity is obliged to take care to ensure that these descriptions are clear and comprehensible to investors.

IOSCO requires the responsible entity to not consider disclosure of liquidity risk, and information about its liquidity risk management process, to be a substitute for the actual operation of an effective policy.

Basic day-to-day liquidity information (for example, the dealing frequency of the CIS and how to buy/sell units) is expected to be disclosed to investors.

Day-to-day Liquidity Risk Management Principles

Principle 8

The responsible entity's liquidity risk management process must be supported by strong and effective governance

Governance is of paramount importance for an effective liquidity risk management process, as even the most sophisticated liquidity modelling and perfectly predicted cash flows can be made redundant by the lack of effective oversight or controls to deal with the information produced. Appropriate escalation procedures ought to also be in place if problems are envisaged or identified.

Governance arrangements are also expected to ensure that risks to the CIS are considered and managed as a whole (for example, as noted earlier, the inter-relationship between valuation and liquidity).

Again, related to the particular governance structure and size of the responsible entity, it is suggested that there be an appropriate degree of independent oversight involved in reviews of the liquidity risk management process.

Principle 9

The responsible entity should effectively perform and maintain its liquidity risk management process

After a liquidity risk-management process is established pre-launch, it has to be effectively performed and maintained during the life of the CIS. The remainder of the principles in this section set out some of the relevant considerations relating to such performance and maintenance.

In performing its liquidity risk management process, the responsible entity is expected to take account of the investment strategy, liquidity profile and redemption policy of the CIS. The liquidity risk management process is required to also take account of obligations of the CIS other than investor redemptions (for example, delivery and payment obligations such as margin calls, obligations to counterparties and other creditors).

The liquidity risk management process could be performed as part of the wider risk-management arrangements adopted by the responsible entity, involving resource from its risk management and/or compliance functions (where relevant). Risk management and measurement arrangements that are more adaptive (rather than static) and systems that can rapidly alter underlying assumptions to reflect current circumstances are likely to be at the forefront of good liquidity risk management, as are those which utilise a wide range of information and different perspectives and those which incorporate varied scenario analysis in their performance.

Regular periodic reviews of the effectiveness of the liquidity risk management process are supposed to be undertaken by the responsible entity and the process ought to be updated as appropriate. An additional review and possible updates may also be necessitated by the occurrence of certain events. For example, if the CIS is to invest in a new type of asset or if the investor profile has changed materially (from that anticipated) – for example, if a CIS originally expected to have a large number of retail investors but in fact only attracts a small number of institutional investors each owning a significant share of the CIS – it is recommended that the policy be reviewed and updated, if deemed appropriate.

Principle 10

The responsible entity should regularly assess the liquidity of the assets held in the portfolio

The liquidity risk management process is expected to enable the responsible entity to regularly measure, monitor and manage the CIS's liquidity. IOSCO suggests that the responsible entity take into account the interconnection of liquidity risk with other risk factors such as market risk or reputational risk.

It is recommended that the responsible entity ensure compliance with defined liquidity limits and the CIS's redemption policy, whether these are set by national regulation of a non-Gibraltar fund being managed from Gibraltar, set out in the liquidity risk management process, detailed in the CIS's documentation or other internal thresholds.

The liquidity assessment of the CIS's assets ought to consider obligations to creditors, counterparties and other third parties. The time to liquidate assets, the price at which liquidation could be effected and the financial settlement lags and the dependence of these on other market risks and factors, are expected to form part of the assessment of asset liquidity.

Principle 11

The responsible entity should integrate liquidity management in investment decisions

IOSCO advises that the responsible entity consider the liquidity of the types of instruments it intends to purchase or to which the CIS could be exposed, as well as liquidity effects of the investment techniques/strategies it uses, before transacting; and the impact that the transaction or techniques/strategies will have on the overall liquidity of the CIS. Responsible entities are supposed to only carry out transactions if the investment or technique/strategy employed does not compromise the ability of the CIS to comply with its redemption obligations or other liabilities.

The assessment of liquidity risk includes the consideration of the type of asset and where applicable trading information (for example, volumes, transaction sizes and number of trades, issue size) as well as an analysis, for each type of asset, of the number of days it would take the responsible entity to sell the asset without materially moving the market prices.

For OTC securities other information may be more meaningful in delivering comparable analysis, such as the quantity and quality of secondary market activity, buy/sell spreads and the sensitivities of the price and spreads.

Liquidity risk management is required to also consider collateral arrangements (for example, to take account of the risk of deterioration in the quality of collateral received from a counterparty in a derivative transaction, if it were to become illiquid). The liquidity "quality" of securities accepted as collateral is recommended to be evaluated on an ongoing basis, in light of collateral arrangements actually in place (for example, segregation of collateral accounts, unavailability of collateral for investment purposes, haircut thresholds and so on). With respect to derivative transactions, the responsible entity ought to ensure that the quantity of liquid assets is sufficient to meet settlement of margin calls.

The responsible entity is suggested to take exceptional care if utilising tools such as temporary borrowing to manage liquidity. Not only will the CIS incur a financial cost for this, but if the temporary borrowing does not solve the problem then the CIS may need to suspend or wind-up and it will at this point be leveraged, potentially with exacerbated problems. Investors in the CIS that benefit from the borrowing (by being able to redeem) may not be the ones paying the costs of it (remaining unit-holders). However, there may be some cases where inflows can be predicted with some certainty (e.g., if there are substantial regular monthly contributions into the CIS), which mitigate the risks involved with temporary borrowing.

Where a CIS is winding-up, the responsible entity is expected to consider liquidity issues, along with any legal requirements or relevant conditions set out in the CIS's constituting documents, and balance the early return of proceeds to investors with the need to secure a fair price for the CIS's assets.

Principle 12

The liquidity risk management process should facilitate the ability of the responsible entity to identify an emerging liquidity shortage before it occurs

The liquidity risk management process ought to aim to assist the responsible entity in identifying liquidity pressures before they crystallise, thus enabling it to take appropriate action respecting the principle of fair treatment of investors.

Retail investors, in particular, will have a general expectation that, in normal circumstances, the CIS will be able to meet redemption requests on the standard terms set out in its offering documents. While the use of exceptional measures may enable a liquidity issue to be "managed", by restricting investor redemption rights, it is preferable to avoid this if possible (see principle 4 above). Where a responsible entity has a choice as to whether to apply an exceptional measure – or a tool - that could affect redemption rights at all, or which of several tools or measures to apply, it is obliged to make this decision in the best interests of unit-holders.

Responsible entities are advised to make best efforts to manage future cash flows so as to assist with liquidity management (for example, it may be possible to negotiate a pre-notice period with brokers before changes in margin call formulas become effective, or to negotiate longer periods for repo agreements).

Principle 13

The responsible entity should be able to incorporate relevant data and factors into its liquidity risk management process in order to create a robust and holistic view of the possible risks

In performing the liquidity risk management process, the responsible entity is suggested to consider quantitative and qualitative factors to seek to ensure that in all but exceptional circumstances the CIS can meet its liabilities as they fall due.

Key information ought to be taken into account which, where known or available or subject to sensible estimate, could improve the capability to predict liquidity risk. Consistent and verifiable statistical methods can be used to generate data and scenarios where appropriate – scenarios can relate to the behaviour of investors and/or the CIS assets.

Ideally, responsible entities are expected to have some degree of knowledge of the CIS's investor base, and where possible, interact with relevant intermediaries to secure pre-notification about removal from a "best-buy" list or similar.

While ensuring the fair treatment of all investors, and no preferential disclosure to select investors, a responsible entity could identify investors with a large unit-holding in the CIS, and keep up-to-date about whether they intend to make significant redemptions. However, this ought to be done in a way that avoids any conflicts of interest, between the responsible entity and such investors, that cannot be properly managed from arising.

Principle 14

The responsible entity should conduct assessments of liquidity in different scenarios, including stressed situations

As part of the implementation of the liquidity risk management process, appropriate assessments are supposed to be carried out by the responsible entity of the liquidity risk to the CIS in normal and stressed scenarios (for example, atypical redemption requests).

For example, the responsible entity could analyse the number of days that it would take to sell assets and meet liabilities in the stressed scenarios simulated, taking account of the expected behaviour of other market participants in the same conditions, and any actions the responsible entity would take (e.g. imposition of contingent liquidity management tools). In respect of collateral an assessment could be used to demonstrate that the quantity of liquid assets is sufficient to meet settlement of margin calls on derivatives positions.

Assessments are recommended to be based on reliable and up-to-date information, and the results taken into account in performing and maintaining the liquidity risk management process. Feedback from any real situations experienced ("back-testing") is advised to be used to improve the quality of output from future assessments.

Responsible entities could also conduct assessments related to other market risks and factors. For example, it may be appropriate to assess the impact of a credit rating downgrade of a security held by the CIS as one factor, as such a downgrade can affect the security's liquidity and that of the CIS. Reputational risk from a problem with another aspect of the responsible entity's business, or problems experienced in a similar CIS run by another entity, could cause unexpected redemption requests.

Assessments ought to be carried out at a frequency relevant to the specific CIS.

Principle 15

The responsible entity should ensure appropriate records are kept, and relevant disclosures made, relating to the performance of its liquidity risk management process

As part of performing their liquidity risk management process, responsible entities are expected to be able to demonstrate (to the FSC, for example) that robust liquidity arrangements are in place and that they work effectively.

In order to support the successful implementation of and adherence to the process, it is suggested to be effectively documented and communicated across the responsible entity's business. Such documentation should be reviewed as needed, and at least annually in any event. Regular reporting requirements may require risk disclosures, for example in the CIS's annual report, and in some cases it may be appropriate to detail liquidity risks or issues in this context.

Where there has been a material change to liquidity risk either in level (that is, in the markets relevant to the CIS's portfolio), the responsible entity's approach or, for example, if the responsible entity is planning to introduce a new tool or exceptional measure (see principle 4 above) that could affect redemption rights or change the CIS's dealing policy, IOSCO recommends that the responsible entity inform investors appropriately.

Where an exceptional measure is applied (e.g., the imposition of a side pocket), existing and potential investors are required to be informed in an appropriate manner, and kept informed over time (for example, by material on the responsible entity's website).

Summary

The above principles are supposed to be considered in respect of prudent liquidity management of Gibraltar Funds. In doing so the nature and complexity of the investment strategy and assets involved are expected to be considered and these principles applied in a proportionate manner accordingly. The objective of this is to help mitigate the risk of liquidity issues, which can adversely affect investors.

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Regulatory objectives and principles of good regulation – checklist

Which regulatory objectives are the proposals aimed to facilitate?	
(a) To promote market confidence;	Yes –Ensuring good liquidity risk management is exercised ensures investors are able to withdraw monies upon request and maintain confidence in investing in funds.
(b) The reduction of systemic risk;	Yes – Implementing these principles promotes confidence in funds and the use of such in portfolios.
(c) To promote public awareness;	No – this Newsletter is aimed at industry and includes measures regulators are advised to take when considering this area.
(d) The protection of the reputation of Gibraltar;	Yes – Introducing international standards reflect the standing of the jurisdiction and its goal to ultimately protect investors.
(e) The protection of consumers;	Yes – as above
(f) The reduction of financial crime, including the funding of terrorism;	No – whilst this area is inherent in the management of funds, the principles deal specifically with liquidity risk management.
Do the proposals accord with the following principles of good regulation?	
1. The need to use our resources in the most	**Yes, duplication of the IOSCO guidelines**

efficient, effective and economic way;	**via a Newsletter.**
2. The principle that the duty to manage a business falls upon the senior management of that business. The Directors of a licence holder, both executive and non-executive have ultimate responsibility for ensuring that the business is properly run and operates in accordance with regulatory requirements;	**Yes, this Newsletter makes reference throughout to the "responsible entity" and is not prescriptive.**
3. The principle that a burden or restriction which is imposed upon authorised firms ought to be commensurate with the benefits expected to result from such action, so ensuring that the Authority is striking the right balance between achieving the statutory objectives and ensuring that the impact on those being regulated is not such as to be counterproductive;	**The guidelines are aimed at providing areas that funds need to consider to ensure appropriate operation of the Fund in respect of liquidity management.**
4. The desirability of facilitating innovation in connection with regulated activities;	**As the guidelines are high level it is not expected to hinder innovation.**
5. The international character of financial services and markets and the desirability of maintaining the competitive position of Gibraltar; and	**IOSCO guidelines have been presented in this Newsletter hence providing an internationally recognized standard and level playing field.**
6. The need to consider the adverse effects of regulation on competition and consumer choice.	**The content of this Newsletter is not expected to impede investor choice.**
7. Does this match UK supervisory practices	**These are guidelines issued by IOSCO hence will be applied at international level in all relevant jurisdictions.**