

Keynote speech: Liquidity Risk Management of Investment Funds ASIFMA-GFMA Market Liquidity Conference 2016

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Good morning ladies and gentlemen.

I would like to thank ASIFMA for inviting me to deliver the keynote speech at this year's market liquidity conference.

My focus today is on liquidity risk of open-ended funds. As you well know, liquidity has emerged as an important topic for policymakers and regulators worldwide.

Now one way to look at this topic is from a macro perspective. Over the past eight years since the first quantitative easing, the talk has ranged from how the torrent of liquidity unleashed by highly accommodative monetary policies has inflated asset prices, to how it has led to a build-up of leverage and compression of risk premia.

But from a micro, market dynamic perspective, the concern is completely different. It is about the apparent decline in bond market liquidity resulting from dealers' reduced market-making capabilities as well as the significant increase in stress incidents where market liquidity evaporates all of a sudden.

These macro and micro forces have combined to produce a rather odd phenomenon where more liquidity is actually less. And this is what market participants are living with today.

Now this has caught the attention of regulators for a number of reasons. First, open-ended funds have been growing rapidly and are now a force to be reckoned with. Second, a significant proportion of the increase in their asset holdings is in less liquid markets which are particularly ill-equipped to absorb market or liquidity shocks. Third, certain structural features of these funds could make them susceptible to liquidity risk.

Defining liquidity risk

Before going further, let me first define what I mean by liquidity risk at open-ended funds. Liquidity risk refers to the risks that arise as a result of the mismatch between the liquidity profiles of the assets and the liabilities of open-ended funds.

The key issue here is that many funds offer daily dealing. Of course, this is less of an issue for funds that invest in highly liquid securities, such as main board equities which managers could readily dispose of to meet redemptions or private funds which are typically subject to gates and less frequent dealing feature, such as quarterly or even half-yearly dealing.



But as open-ended funds venture into more exotic and less liquid assets, the gap has continued to widen between the liquidity that these funds promise investors on the one hand, and the liquidity that they can obtain from their underlying investments on the other.

At a micro level, failing to manage this risk properly could mean that funds cannot meet redemption requests or can only do so in a way that may be prejudicial to the interests of remaining investors. At a macro level, some are concerned that mismanagement of liquidity risk associated with open-ended funds could lead to fire sales in the underlying asset markets, potentially causing market volatility or making it worse.

This is why both market regulators and macro-prudential regulators have taken a keen interest in the liquidity risk management of open-ended funds. For instance, recently the Financial Stability Board identified liquidity risk as a potential vulnerability in the asset management sector.

Next time may be different

But not everyone is convinced about the severity of these liquidity risks. Historically, the fund sector has generally been resilient in the face of market and liquidity events, even during the tumultuous time of 2008, with the exception of constant NAV¹ money market funds. But some regulators, particularly macro-prudential regulators, are seeing signs that next time may be different.

Their concern stems from a major liquidity illusion, which works like this: asset managers pile into a certain asset class. As a result, price rises and the risk premium falls, together with volatility. Liquidity seems plentiful amid high turnover. Market participants come to see assets as safe and liquid, and underestimate the difficulties of exiting their investments when the music stops.

This is not unlike what academics call the turkey illusion. Feed the turkey good food every day, and the turkey will come to expect more good food in the days to come. So far so good—until Christmas Day when it's time to prepare the turkey dinner.

This turkey analogy probably resonates among some of you managing funds with exposure to the A-share market. Some markets, such as emerging market fixed income securities, are known to be illiquid and investors are alert to this. But equities markets are generally seen as liquid.

Events in the past 12 months have challenged this accepted wisdom. First there was the A-share market correction last summer. More than half of the listed stocks suspended trading after hitting price fall limits or citing various reasons to voluntarily suspend trading. Then there was the short-lived circuit breaker, which brought the whole market to a standstill multiple times in the first week of 2016. During these episodes, fund managers were rudely awakened to the fact that, actually, equities could be illiquid too.

And it was not just fund managers. The SFC was also on high alert, since many Hong Kong funds invest in the Mainland market, including some of the largest and most popular funds. Since the A-share market correction began last summer, we have stepped up our fund surveillance work. We sought daily reports from managers on redemptions exceeding 5% of

¹ Net asset value



NAV. We also asked managers to report to us if their funds have problems meeting redemptions or face other liquidity issues.

Our worst fears of fire sales and systemic instability did not materialise. But at the individual fund level, we have seen major redemptions – many exceeding 20% and some even reaching 80%. The funds concerned were able to meet redemptions and did not have to take extraordinary actions such as suspending dealing or winding down the funds. But it was clear that redemption rates could be much higher than what we have seen historically. Or to put it in statistical terms, the redemption rate bell curve may have a low average, but it could have a fat tail.

Then in December last year, just as the Mainland market was regaining its footing, another incident broke out, this time with the announcement that the Third Avenue Focused Credit Fund, a regulated publicly offered mutual fund in the US, suspended redemptions and was wound down.

In that incident, when a sizable high yield bond fund was liquidated we did not see spillover to other high yield bond funds or a fire sale in the underlying asset markets. But although no wider financial stability issues were touched off, this event demonstrated that a large, sudden redemption and liquidity crunch is not just a distant theoretical possibility. As a regulator, we are concerned about how prepared fund managers are for these liquidity events and whether investors are treated fairly in these episodes.

Complexity and its implications

There is no doubt that liquidity risk management is a complex subject. At a very basic level, it is about making sure that funds have sufficient liquidity to meet large and sudden redemptions. But this is only part of the story. Just as importantly, it is about how to make sure that all investors are treated fairly. With this in mind, we recently conducted a focused review of the liquidity risk management practices of managers of SFC-authorized funds in Hong Kong.

In the course of our review, the most commonly seen issue involved how managers dispose of assets to meet redemptions and whether the cost was fairly allocated among redeeming and remaining investors. Some managers may simply sell the most liquid assets, which are the most likely to find a buyer at the current price. But if the redemption was large and was not accompanied by new inflows to facilitate rebalancing, this disposal strategy could leave the remaining investors with a basket of less liquid assets and put them on the hook for the cost of reconstructing the portfolio in line with the stated investment strategy.

In other cases, managers could dispose of assets in proportion to each type of asset holding. But that would mean selling less liquid, but potentially good quality, assets on the cheap. We have seen that a few managers did try to use tools such as swing pricing to allocate the portfolio rebalancing costs to the redeeming investors. But others didn't.

The second area is fair valuation of fund assets. Usually, under normal market conditions, the last traded price is used to value fund assets. But a quick survey done during the period of widespread suspension of A-shares indicated that some managers did not have comprehensive valuation policies and procedures to deal with situations when fund assets become illiquid or when market values become unreliable. This could potentially disadvantage the remaining investors.



A third area is governance. We have observed that some managers have robust and independent liquidity risk management functions, and they monitor the liquidity of their funds on an ongoing basis. When internal liquidity targets are not met, as was the case in the first week of this year, there was immediate escalation to senior risk managers for an action decision. However, we have also observed inadequate practices where such decisions were left to portfolio managers in market stress situations.

The fourth area has to do with funds' investor profiles and redemption patterns. We have noticed that those funds which suffered from sudden and large redemptions of 60% or more were often funds whose investor base was concentrated in a few large institutional investors. Anecdotally, we were told these investors were unable to raise cash amid the liquidity crunch on the Mainland and therefore drew liquidity from their fund investments in Hong Kong. This episode may point to a need for fund managers to take into account the diversity of the investor base and their redemption patterns when monitoring the liquidity of the portfolio and conducting stress testing.

The fifth area relates to exchange-traded funds (ETFs). The sell-off last summer provided some interesting case studies on the resilience of ETFs in market stress situations. When the A-share market fell by 30% in a matter of weeks, we did see some large redemptions of A-share ETFs. But even more remarkable was the rise in secondary trading of A-share ETFs listed in Hong Kong.

We observed that in one case, total redemptions of a large A-share ETF during the 6-17 July market stress period ran up to about \$6 billion, whereas the daily market turnover on the HKEX was about \$5.5 billion. The turnover during the period was up by almost 80% from the preceding months and it appears that liquidity in the secondary market may have alleviated the selling pressure on the underlying stocks. But ETFs faced their own issues too. Trading discounts of some A-shares ETFs shot up during those volatile months. The US Financial Stability Oversight Council has noted this as a potential area of concern from a financial stability perspective, though regulators are still trying to work out all the implications.

Regulatory responses

I hope that by now you have a sense of the complexity and seriousness of the liquidity risk at funds. It certainly is an area that regulators around the world take seriously. For example, in 2013 the International Organisation of Securities Commissions (IOSCO) issued a set of principles on valuation and another set on liquidity risk management, and it is now planning to consult the industry on this subject. Meanwhile, the Financial Stability Board is working on a coherent framework to analyse and address the vulnerabilities of the asset management industry.

Not surprisingly, here in Hong Kong, the SFC has also dedicated considerable resources and attention to this area. Last July, the SFC issued a circular on fair valuation to provide guidance on the valuation policies and procedures of SFC-authorized funds, particularly where the market value of a fund asset is unavailable or becomes illiquid as a result of significant market events.

Based on the outcome of our focused review and our study of international best practices, we have compiled a set of guidance on liquidity risk management which is applicable to managers of SFC-authorized funds. The guidance is intended to be principles-based and non-prescriptive because we are conscious of the diversity of the fund universe, and we also



recognise that it is the fund manager's fiduciary duty to meet liquidity needs and treat investors fairly. We have consulted the industry and received very useful feedback, including from ASIFMA and we will have due regard to the comment that the industry needs a period of transition. We are now finalising the guidance which will be published shortly.

This guidance covers five key areas.

First, it covers governance at the firm level. The key idea is that to deal with both day-to-day liquidity issues and exceptional situations, firms should have proper and up-to-date policies and procedures as well as effective and independent personnel and oversight.

The second area is product design. Using an accounting analogy, the two sides of the fund's balance sheet should be balanced. What I mean is that the fund's investment strategy and asset holdings should be consistent with its redemption policy and liabilities. To achieve this, the manager would need to understand the fund's investors and their redemption behaviour. The manager would also have to consider issues such as dealing frequency and maximum fund size, among others.

The third area is the need to monitor the liquidity profile of the fund on an ongoing basis. Here we expect fund managers to classify assets into different liquidity categories, and to set internal targets or indicators on how much of the funds' assets should be held under each bucket. But here I want to emphasise that our proposed guidance does not envisage hard targets or mandatory cash buffers to be set by regulators.

The fourth aspect, on stress testing, concerns how liquidity positions may change under stressed market conditions. We believe managers should regularly perform stress testing to assess the impact of plausible adverse changes in market conditions as well as the adequacy of the funds' action plan and risk management tools.

The final aspect of the guidance relates to liquidity risk management tools. These are what managers could use when facing large redemptions. Our central recommendation is that managers should make sure that they have the necessary tools in place, have clear procedures and clearly demarcated responsibilities surrounding the tools' implementation, and that they appropriately disclose these tools to investors. When deciding whether particular tools should be used, investors' interest should always be the primary consideration.

Conclusion

Ladies and gentlemen, liquidity events that used to be considered "black swans" are occurring more and more often, and it seems the black swans are turning a bit grey. And as I said at the beginning, we are witnessing this odd phenomenon of "more is less".

In Asia, the liquidity of emerging market debts, which is fair at best, may be settling into a new equilibrium of lower liquidity. Events of last year were an awakening to fund managers and dealers that they must learn to live with less and make their funds more resilient to liquidity shocks. I would like to conclude here with that, and wish you a successful conference today.

Thank you.