Institute and Faculty of Actuaries

Illiquid assets and open-ended investment funds: DP17/1

IFoA response to Financial Conduct Authority

8 May 2017

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Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

Mark Glibbery
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8 May 2017

Dear Mr Glibbery

IFoA response to FCA Discussion Paper DP17/1: Illiquid assets and open-ended investment funds

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the FCA's consultation 'Illiquid assets and open-ended investment funds'. Members of the IFoA's Finance and Investment Board have been involved in the drafting of this response, including members who work for unit-linked life fund providers.

2. The IFoA believes it is timely and relevant that the FCA has opened a discussion about how fund managers could improve the liquidity of the open-ended funds they manage. We welcome the Discussion Paper's recognition that making it more practical to invest in illiquid assets can benefit not only investors but also the wider economy, for example through increasing private investment in infrastructure. We believe that the current structure of the open-ended fund market, while not perfect, has the key benefit that it gives consumers access to illiquid assets that would very difficult to invest in directly. In normal conditions it also provides greater liquidity than could be achieved through direct investment. However, at those times when it is necessary to take measures to restrict liquidity, it is vital to ensure that this is well understood by customers. It is important to recognise that managing these funds in stressed market conditions is difficult and requires a significant level of judgement. There is no single correct answer in any situation and a range of valid approaches are possible. The key is for fund managers to have robust systems, controls and governance and for the interests of the customer to be at the forefront of their considerations.

3. The Discussion Paper includes a useful analysis of how property fund managers responded to the result of the EU Referendum in June 2016, and notes that many unit-linked life funds with property exposure made adjustments to reflect pricing adjustments in the underlying funds. We comment in more detail on unit-linked funds below.

4. The following comments focus on those consultation questions where we have specific points to add or concerns to express.

Q1: Do you have any comments on our description of the types of inherently illiquid assets that might be held in open-ended funds? Are there others you would consider inherently illiquid?

5. We agree with the listed examples of illiquid assets that could be held in open-ended funds. We would also add insurance linked securities and catastrophe bonds to this list.

Q2: Do you have any observations on our analysis of liquidity management tools? Are there other factors affecting the liquidity management of open-ended funds investing in illiquid assets that we should take into account?

6. Chapter 3 on Liquidity Management Tools makes reference to portfolio investment limits. One problem with such limits is that they can impede investment strategy. If redemptions are running at a high level this can make it very difficult to stay within the limits. The manager is forced to reduce investment levels, at the expense of existing investors, in order to re-align to liquidity management ‘guidelines’.

7. Another approach used by some property funds at the time of the EU Referendum was to defer a proportion of dealing requests when such requests exceeded a threshold level. We recognise that such ‘gating’ does present operational issues for platforms. For Defined Contribution platforms, daily dealing is an operational but not a regulatory requirement. This means that illiquid assets can only be accessed underneath another fund structure, where cash flow is managed by a manager, such as multi asset funds.

8. When gating ability is required by the underlying fund behind a unit linked policy, the insurer will only add the fund to the range when the probability of gating is sufficiently low. This means that only large funds with diversified client bases will be accepted onto the platform, which can be a problem for more niche forms of illiquid assets.

9. The Discussion Paper notes that fund managers can seek to understand investor behavior by analysing redemption patterns. However, this approach has limitations if there is no single, clear reason why an asset class falls out of favour with a group of investors.

10. We note that some liquidity management tools are available to unit-linked funds but not to mutual funds:

    a. Firstly, some directly-invested unit-linked funds can continue to accept regular or single premium payments when they are placed into deferral, depending on the contractual terms and the provider’s systems. This is different to mutual funds where a fund suspension means that no money can go in or come out. The ability to continue to accept money in can offset contractual payments.
    b. Secondly, some providers are able to operate a queuing mechanism for discretionary payments while the fund is in deferral. This means that as assets are sold from the fund, policyholders who have requested discretionary payments can be released from the queue as liquidity becomes available. Only when all claims have been paid from the queue and liquidity in the fund has returned to stable levels will the fund deferral be lifted. The ability to operate a queue can be useful to the fund manager, since it provides an indication of the level of demand that can be used to establish an appropriate sales programme.

11. The ability of an insurer to defer payments on unit-linked funds will also depend on the contractual terms which may only permit the insurer to defer discretionary payments for a maximum period of time e.g. 6 months or 12 months. This can create additional liquidity strain for insurers if either they are unable to sell sufficient assets within the maximum deferral period, or if the collective investment scheme that the insured fund is linked to is still suspended at the end of the maximum deferral period.

Q7: Do you think our analysis of the possible benefits and risks of direct intervention by the regulator is correct? Do you think the FCA should be more proactive about directing the actions of fund managers in a stressed situation, and if so how?

12. We do not believe there is any need for the FCA to direct the actions of fund managers more proactively in a stressed situation. However, there may be value in the FCA monitoring the application of liquidity management tools to ensure that they are being used consistently and appropriately and that any potential conflicts of interest are being managed appropriately.

Q9: What is your view of the benefits and risks of a secondary market in the units of open-ended funds investing in illiquid assets? Should the FCA do more to encourage the development of such a market?

13. In the IFoA's view a secondary market would be very difficult to operate in practice. In particular, it is hard to envisage how it would work for insured funds where the policyholder does not own the underlying units.

14. If you would like to discuss any of the points raised in further detail please contact Matthew Levine, Policy Manager (matthew.levine@actuaries.org.uk / 0207 632 1489) in the first instance.

Yours sincerely

Colin Wilson
President, Institute and Faculty of Actuaries