New City
Initiative

The Conundrum of Liquidity Regulation

Observations from the Boutique SME Asset Manager

About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of asset management.

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, a traditional "client-centric" approach has enabled entrepreneurial, owner-managed firms to emerge as an important force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

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Foreword

Liquidity is something that is often talked about in financial markets, usually when it is perceived to be absent. However, an exact and consistent definition is elusive and attempts to clarify matters are often forgotten and inherently difficult to isolate for analysis. What does seem to be agreed is that more liquidity is a good thing, although even that may not be the case if the liquidity comes from inflationary monetary policy. Where the risk of failures in liquidity lie and should lie is more contentious.

Historically, much liquidity risk was held within the banking sector: banks naturally take liquid deposits and make illiquid information-intensive loans. Recently, regulation has constrained banking activity and this has led to a transfer of liquidity risk to other sectors such as asset-management. This has unintended consequences, as discussed in this paper, and may not serve investors or the broader economy well: many asset management strategies explicitly rely upon liquidity transformation and the interconnectedness of different components of the financial services sectors means that regulation that affects one part has a corollary, perhaps unintended, consequence on another sector.

An intelligent and thoughtful approach to regulation and policy is in everyone's interests. NCI acts as a catalyst for discussion and I am very pleased to introduce this paper, which takes a reflective and broad view of liquidity risk and the policy landscape that addresses it.

Jamie Carter
Chairman, New City Initiative
Chief Executive, Oldfield Partners

Executive Summary

NCI discusses various aspects of regulation of liquidity risk, considering the interconnectedness between different components of the financial ecosystem. Changes to bank regulation have led to a curtailment of liquidity provision to the asset management sector, both at the fund level and at the security level, and this has had a disproportionately negative effect on smaller asset managers. Recognition of this shift in liquidity risk from banks to asset managers has prompted its own regulatory response that fails to distinguish adequately between asset managers of different character. NCI argues that small and medium-sized active asset managers have a stabilizing effect at the margin, adopting innovative strategies, well-communicated to investors, that can be counter-cyclical in times of constrained liquidity. NCI recommends a new and diverse dialogue in which the voices of these SMEs of the financial services industry are clearly heard and which recognizes the interconnectedness and transformation of risk that is inherent in financial markets.

Introduction

New City Initiative (NCI) has over forty members collectively managing around £400 billion of assets. Predominantly owner-managed, NCI's members align their interests with their clients' in a transparent manner and, more broadly, seek to encourage competition, innovation and consumer choice within the UK asset management industry.

This paper explores the effect of liquidity risk on the asset management sector and the unintended consequences of governmental intervention since the Global Financial Crisis (GFC) of 2007-2009. Changes in bank regulation have led to deleveraging of banks and a reduction in credit provision, especially to SMEs. This has transferred liquidity risk away from the banks, including to the asset management sector, which engages in liquidity transformation by investing in less liquid assets. Recognition of this transfer of risk has led to new regulation affecting asset managers, yet its operation does not sufficiently distinguish between different types of asset managers.

NCI argues that the small and medium-sized asset managers, predominantly active, that constitute its members: act as stabilizers of liquidity, dealing in a contrarian manner when index-following funds cannot; have as investors those who are fully informed of the risks and the liquidity transformation that is undertaken; are disproportionately affected by reduction in bank liquidity provision to SMEs, and; should be positively distinguished in future policy and regulation.

Curtailment of Bank Liquidity

The GFC still figures within myriad elements of modern society: economic components, such as financial markets and monetary and fiscal policies; psychological components, such as instability, fear and crises of authority, and; sociological components, such as social justice and the morality of the socialization of losses.[1] NCI's foundation was within this context, offering a model of alignment between asset managers and investors to act as an example to the wider financial services industry.[2]

One such trend is the regulatory-driven deleveraging of bank balance sheets.[3] This operates both in absolute terms and in terms of which market segments are provided with funds.[4] Substitution through development of "shadow banking" entities have followed and a transition of liquidity risk from the banking sector to entities such as asset managers.[5] The disproportionate effect of reduced access to capital on innovation by SMEs has previously been considered by NCI.[6]

As will be discussed below, the effect acts indirectly as well as directly, since reduced access to bridge liquidity affects the operation of investment funds themselves in terms of redemptions and investment strategy. Consequently, the change imposed on the banking sector derivatively affects the asset management sector, notably in the operation of liquidity transformation: offering liquidity in fund units whilst investing in illiquid assets as part of any investment strategy.

Liquidity Transformation by Asset Managers

Liquidity transformation is core to the operation of many financial intermediaries.[7] By way of example, banks provide investors with highly liquid demand deposits whilst making illiquid information-intensive loans.[8] This traditional role of the banking system has extended, in response to the regulatory environment discussed above, to what is referred to as the "shadow banking" sector.[9]

Asset managers, which typically allow investor withdrawals at short notice, can invest in illiquid assets such as real estate, loans, emerging market stocks and much else. Consequently, asset managers engage in a liquidity transformation process: they exchange liquid participation by investors for illiquid assets, just as banks take liquid deposits and make illiquid loans.[10] The degree of liquidity transformation depends on the fund strategy, namely what it invests in, and will be time dependent, namely the liquidity of these assets will vary with market conditions. Consequently, asset managers have been viewed, at various times, as part of the shadow banking

1 The Global Financial Crisis and its Aftermath: Hidden Factors in the Meltdown (A G Malliaris, L Shaw and H Shefrim eds, OUP 2016), pp 3-24
2 New City Initiative, Alignment of Interests: Fixing a Broken City (2010); New City Initiative, Alignment of Interest: How Culture Defines Boutiques (2017)
3 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC ("CRD IV") OJ L 176/338
4 G Wehinger, 'Bank Deleveraging, the Move from Bank to Market-Based Financing, and SME Financing' (2012) 1 OECD Journal: Financial Market Trends
5 European Systemic Risk Board (ESRB), Assessing Shadow Banking - Non-Bank Financial Intermediation in Europe (Occasional Paper No 10 / July 2016, 2016)
6 New City Initiative, Boutique Asset Management: An SME Cluster (2017)
7 D W Diamond and P H Dybvig, 'Bank Runs, Deposit Insurance, and Liquidity' 91 Journal of Political Economy 401
8 G Gorton and G Pennacchi, 'Financial Intermediaries and Liquidity Creation' 45 The Journal of Finance 49
9 Moreira A and A Savov, 'The Macroeconomics of Shadow Banking' 72 The Journal of Finance 2381
10 S Chernenko, A Sunderam and National Bureau of Economic Research, Liquidity Transformation in Asset Management: Evidence from the Cash Holdings of Mutual Funds (2016)

sector.[11] Contrary arguments have been advanced: that asset managers are merely a veil for underlying investors, transacting in assets on behalf of investors without liquidity transformation, or;[12] that asset managers are aware of liquidity risk and actively manage that risk.[13] These counter-arguments have obtained limited traction.

It is submitted that, not least owing to the considerable disclosure now required, investors know the degree of liquidity transformation undertaken by asset managers and reflected in two key metrics:[14] the underlying strategy and assets invested in, and; the redemption policy to which investors are subject. This must yet more be the case where the investors are institutional with the resources and sophistication to understand and take professional advice.

Indeed, many of the return profiles of investment processes are, although not usually conceptualized in this manner, a function of the liquidity transformation: it cannot reasonably be the case that investors in a real estate fund genuinely believe the underlying assets to be liquid; rather, articulated or not, they are making the investment knowing that they are in some sense receiving a liquidity risk premium that is time-varying and market-dependent. This example illustrates that any liquidity transformation is activity-based (i.e. what the fund does and what it invests in) rather than entity-based (i.e. being an asset manager): such has been acknowledged in parts by regulators.[15]

Active Managers and Counter-Cyclical Liquidity

The beneficial effect of counter-cyclical provisioning with the banking sector has been established: it can smooth credit supply and support firm performance.[16] Its capacity to do so is restricted in times of true global crisis, such as that between 2007 and 2009, and liquidity provision was maintained by explicit support from government:[17] nonetheless, this is itself a form of counter-cyclical support, albeit one from the public sector.

However, banks are not the sole providers of liquidity and appetite for public liquidity provision has reduced leading to the bank regulatory changes discussed above. The asset management sector provides liquidity through the liquidity transformation process: investors change their liquidity profile by subscribing to funds that engage in liquidity transformation; they reverse this by redeeming their position in the asset manager's funds.

The effect depends on the nature of the underling fund strategy, namely the assets invested in, and the timing of investor subscriptions and redemptions. However, the index-tracking nature of passive funds means that they buy and sell in concert and are inherently pro-cyclical in conversion

11 European Systemic Risk Board (ESRB); International Monetary Fund (IMF), Global Financial Stability Report. April 2015, Navigating Monetary Policy Challenges and Managing Risks (2015)
12 Investment Company Institute (ICI), ICI Comments on the SEC's Liquidity Risk Management Proposal (2016)
13 Independent Directors Council (IDC), IDC Comments on the SEC Liquidity Risk Proposal (2016)
14 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 ("AIFMD") OJ L 174, Art 23
15 European Systemic Risk Board (ESRB)
16 G Jiménez and others, 'Macroprudential Policy, Countercyclical Bank Capital Buffers, and Credit Supply: Evidence from the Spanish Dynamic Provisioning Experiments' 125 Journal of Political Economy 2126
17 V V Acharya and N Mora, 'A Crisis of Banks as Liquidity Providers' 70 The Journal of Finance 1

of cash into securities and the reverse: lower management fees may be reflective of higher risk in liquidity crisis situations, either to holders of passive investments, who sell in crisis at a price that would be improved upon with patience, or to the wider financial system; in this, it is reminiscent of certain option sale strategies in which a premium obtained in stable markets is more than surrendered in crises through being "short gamma".[18]

Active funds, especially those that seek contrarian opportunities, are inherently counter-cyclical and provide liquidity in times of crisis; subscription terms and fund structure support such activities by often restricting redemption at short notice. Active asset managers, dependent on strategy, can therefore act as stabilisers in terms of liquidity provision: they buy when others sell, and investors knowingly accept this and support it through their acceptance of the fund structure and the implicit liquidity premium that comes from this liquidity transformation. All funds are not the same even if engaged in the same underlying asset activity: an additional classification is degree of active investment.

Liquidity Risk Management in the Asset Management Sector

Asset managers are required, under Art 16 AIFMD, to have an "appropriate liquidity management system" and "adopt procedures which enable them to monitor…liquidity risk".[19] This is supplemented by a duty to conduct stress tests "under normal and exceptional liquidity conditions" and to ensure that "the investment strategy, the liquidity profile and the redemption policy are consistent."[20] This latter language, in Art 16(2), is that of liquidity transformation: the tension between redemption liquidity and that of the underlying assets within the fund.

The origin of the Directive was within systemic concerns following from the GFC.[21] As the President of the European Commission noted upon its approval:

"The adoption of the directive means that hedge funds and private equity will no longer operate in a regulatory void outside the scope of supervisors. The new regime brings transparency and security to the way these funds are managed and operate, which adds to the overall stability of our financial system."[22]

Given the reference to "hedge funds" and "private equity" it is not entirely clear why AIFMD applies equally to smaller asset managers, not least since family offices are excluded:[23] a small fund with a limited pool of sophisticated investors cannot reasonably imperil stability more than a large, sophisticated family office. Nor is any reasonable basis for concern over "hedge funds" and "private equity" apparent: these are very different and not homogenous even within each

18 N N Taleb, Dynamic Hedging : Managing Vanilla and Exotic Options (Wiley 1997)
19 AIFMD
20 Ibid, Art 16(2)
21 Financial Stability Board, Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (2017)
22 European Commission, European Commission Statement at the Occasion of the European Parliament Vote on the Directive on Hedge Funds and Private Equity (2010)
23 Ibid, Preamble at 7

classification, having a wide variety of strategies with entirely dissimilar risk profiles. Moreover, the systemic risk in the GFC came from the most regulated sector:[24] banks. If anything, the only reason that legislation is required in the asset management sector to address structural liquidity risk is that prior regulation has shifted much of that risk from the banking sector: it is naïve to think that risk goes away; it is merely transformed.

Practical guidance for asset managers on liquidity management has been forthcoming from regulators.[25] Statements that the redemption structure must be linked to the investment strategy are sensible but assume that asset managers do not already operate in this manner: given that it is in their own interests to align these objectives, it is submitted that this criticism does not validly accrue to NCI's members. The FCA enumerates certain "liquidity tools" to be applied in times of crisis:[26] not all will be applicable to a given fund owing to structural constraints. These suggestions include imposition of a redemption charge, swing pricing, limiting redemption including deferral and redemption in specie. In most case, such solutions will be unpopular with investors.

More attractive suggestions include holding a liquidity buffer within the fund and borrowing. However, a liquidity buffer reduces performance and will do so increasingly the more illiquid the underlying assets within the fund: a larger buffer will be required by model. Given that investors accept the liquidity transformation, which is itself a source of return, such an approach may disbenefit investors, particularly if they allocate to multiple funds and manage their own liquidity at the top level: institutional investors are very different from modest retail investors.

The historical solution, borrowing from a banking institution, is deprecated to fifth on the FCA's list: such borrowing could be against the fund itself or, by means of repo or prime brokerage, against specific fund assets. Such borrowing has itself been restricted by regulation and by the deleveraging imposed upon the banking sector discussed above.[27] Indeed, the bank deleveraging process means that banks are less likely to provide financing on illiquid assets and, on a fund basis, more likely to lend to large funds under a substantial asset management firm umbrella: such reflects regulatory capital incentives and perceived credit risk.

Smaller funds and managers, and more innovative investment strategies that involve disclosed liquidity transformation, are deprecated and must use the liquidity management strategies that are unpopular with investors. Not only does this disbenefit smaller asset managers it deprives the investor of innovative sources of alpha. Given the crisis in certain retirement savings plans, depriving them of returns is a perverse consequence of liquidity regulation: the risk, as always, goes somewhere else.[28]

24 J Crotty, 'Structural Causes of the Global Financial Crisis: a Critical Assessment of the "New Financial Architecture"' 33 Cambridge Journal of Economics 563
25 International Organization of Securities Commissions (IOSCO), Recommendations for Liquidity Risk Management for Collective Investment Schemes (FR01/2018 (February 2018), 2018); International Organization of Securities Commissions (IOSCO), Open-ended Fund Liquidity and Risk Management - Good Practices and Issues for Consideration (FR02/2018 (February 2018), 2018); Financial Conduct Authority, Illiquid Assets and Open-Ended Investment Funds (DP17/1) (2017)
26 Financial Conduct Authority, Annex 2
27 Financial Conduct Authority, FCA Handbook at COLL 8.4 for example
28 B H Casey, 'The Implications of the Economic Crisis for Pensions and Pension Policy in Europe' 12 Global Social Policy 246

Regulatory Misdirection

The Enigma of Liquidity Regulation

Regulation and legislation have expanded considerably since the GFC and the public policy responses to the challenges faced by the banking sector. This has included an unprecedented injection of liquidity in the global economy by means of quantitative easing whilst simultaneously causing adjustment of the allocation of capital by banks. It is not intended to comment on this broader issue save to observe that the interconnectedness of institutions through financial market liquidity is not new: the failure of LTCM prompted considerable comment, and;[29] a review of prior financial crises shows notable commonality.[30]

What this paper does intend to highlight is the interconnectedness and unintended consequences of regulating one area of the financial services sector without full and thoughtful consideration of corollary outcomes. Disincentivising banks from providing bridge liquidity lines to funds and reducing the attractiveness of repo and prime brokerage arrangements leads to a necessary transfer of liquidity risk to the asset management sector. This withdrawal of liquidity disproportionately affects smaller funds and asset managers, the SMEs of the financial services industry, leading to less competition, reduced innovation and poorer choices for investors.[31] Shifting liquidity risk onto asset managers many be counter-productive: banks have, if properly governed, a core competence in managing liquidity mismatches since it is their quotidian business. Liquidity is taken for granted until it is not present; times of liquidity crises are rare, prompt rapid disproportionate reaction and lessons are soon forgotten; the unintended consequence is especially likely in such circumstances.

Nurturing the Boutique

NCI's members are the small and boutique active asset managers in London and elsewhere, predominantly owner-managed and with a culture of risk control and long-term outcome that comes from alignment of interest with investors.[32] Provision of counter-cyclical liquidity comes from an investment strategy and investment timeline that differs from the majority of the asset management industry. Size begets behaviour highly correlated to the index: by design for passive funds and as a corollary of benchmark and transaction cost for the leviathans of active management.

True active management, the determined innovation and search for value for investors, must come from the boutique active asset management sector. These modestly-sized entities cannot reasonably be a source of system risk and should not be treated as such: their predominantly institutional investors seek them out to provide excess return, accepting the liquidity transformation inherent in each strategy. Like an aileron on an aeroplane or a lateral stabilizer on a ship, boutique asset managers can, if nurtured, assist to direct the financial ecosystem to its harbour: to do so, they must be duly recognized as liquidity-providers and innovators to evolve the financial architecture.

29 P Jorion, 'Risk Management Lessons from Long-Term Capital Management' (2000) 6 European Financial Management 277
30 S Hsu, Financial Crises, 1929 to the Present
31 New City Initiative
32 New City Initiative

NCI Proposals to Support Boutique Asset Management Liquidity Provision

NCI submits that the current situation regarding asset management liquidity risk leads to sub-optimal outcomes for investors and the broader economy: there is insufficient distinction between different asset managers, by size, style and many other metrics such as degree of active investment and contrarian or innovative investment strategies; there is a lack of clarity about the interaction between different regulation affecting liquidity risk management; there is insufficient recognition that many investors knowingly accept liquidity transformation when they invest in a fund, and those that may not, such as retail investors, can be made aware through prominent yet proportionate disclosure of liquidity risk on fund documentation, and; there is an implicit perception that risk can be controlled rather than accepting that it is transformed, risk being an inherent part of the natural world.

NCI therefore proposes the following in relation to liquidity risk with the asset management sector:

1. Focus on investor best interests and the diversity of investors within the asset management space. Sophisticated institutional investors are not well-served by liquidity management techniques such as liquidity buffers in asset classes they understand and purposefully allocate to as part of a wider portfolio.

2. Recognition that many investors understand the role of liquidity transformation in various investment strategies undertaken by the asset management sector, and actively accept this risk as part of the allocation and subscription process: infantilizing institutional investors has the unintended consequence of reducing their returns leading to wider systemic challenges in areas such as public pensions. Less sophisticated investors, such as retail, may be protected by proportionate and prominent disclosure of liquidity risks within the fund documentation applicable to that class of investor.

3. Understanding and acknowledgement of the interaction between liquidity regulation of different components of the financial services sector. Regulatory changes imposed on the banking sector have pushed liquidity risk on the asset management industry by restricting asset-based or fund-based financing for redemptions. This has prompted its own regulatory response: the prior banking regulation has propagated risk elsewhere with likely unintended consequences.

4. Acknowledgement of the fallacy of risk "control". The natural world is risky as are financial markets and the institutions involved in them. Risk cannot be regulated away, merely transformed: that transformation should be intended, insightful and intelligent.

5. Acceptance that smaller asset managers are not, even without the observations above, of sufficient size to cause systemic risk: treating them dissimilarly to family offices and equivalently to large fund behemoths that, owing to size, track indices pro-cyclically is perverse; smaller asset managers add significant value to investors, can provide liquidity when others cannot, and serve, at the margin, as stabilizers in adverse market conditions.

6. Opening of dialogue between regulators, legislators and small and medium-sized asset managers such as those represented by NCI. Feedback, for example to the IOSCO reports, is

dominated by larger asset managers;[33] the risk profile of these firms is very different from that of the innovative and dynamic small and medium-sized boutique asset management sector.

Conclusion

Risk is a part of financial markets as it is a part of the natural world. Liquidity, however defined, is the source of interconnectedness between different constituents of markets and economies: a phlogiston contained within that, if mismanaged, combusts to crisis. Regulation, initially focussed on banks, has led to a reduction in traditional liquidity provision to the asset management sector through bridge financing, repo and prime brokerage facilities. This disproportionately affects smaller asset managers and their clients, the very stabilizers through active counter-cyclical and innovative investment strategies. Regulation to correct the unintended consequences of prior regulation can only go so far: true dialogue is required between all constituencies, and NCI intends to be an active part of that discussion.

33 International Organization of Securities Commissions (IOSCO), Recommendations for Liquidity Risk Management for Collective Investment Schemes; International Organization of Securities Commissions (IOSCO), Open-ended Fund Liquidity and Risk Management - Good Practices and Issues for Consideration

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