IOSCO Consultation on Liquidity Risk Management for CIS

INREV

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Introduction

INREV* welcomes the opportunity to respond to the consultation questions to the IOSCO Consultation on Liquidity Risk Management for Collective Investment Schemes. We share IOSCO's aim to support liquidity in open-ended funds. Therefore, we hope our comments make a constructive contribution to this important initiative from our perspective representing global capital investment into real estate investment funds across the UK and Europe.

Responses to consultation questions

Recommendation 3: Consistency of OEF asset liquidity and redemption terms *(Page 20 – 25)*

The responsible entity should ensure that the OEF's investment strategy and the liquidity of its assets should be consistent with the terms and conditions governing fund unit subscriptions and redemptions both at the time of designing an OEF and on an ongoing basis. The redemption terms that the OEF offers to investors should be based on the liquidity of its asset holdings in normal and stressed market conditions. To this end, when structuring an OEF that allocates a significant proportion of its assets under management to illiquid assets, responsible entities should consider low redemption frequency and/or implementing long notice or settlement periods.

Q1. *Are the identified common components of OEF's structure including notice periods, lock-up periods, settlement periods and redemption caps accurately described? Are there any relevant additional considerations when setting the notice periods, lock-up periods, settlement periods or redemption caps?*

Assessment of Asset Liquidity

- *"Illiquid" assets include those for which there is little or no secondary market trading and buying and selling assets is difficult and time consuming (i.e. weeks or months, not days) even in normal market conditions. Individual transactions of "illiquid" assets may, therefore, be more likely to affect market values.*

We believe that this statement is misleading in the context of real estate and other comparable assets. Specifically, the statement that '*individual transactions of "illiquid" assets may, therefore, be more likely to affect market values*' is this based on selling securities for which the market might move if you sell a large stake. We do not believe this is a key consideration for real estate where the valuation assumption is generally based on selling the whole asset. Transactions in real estate may take months, not because of a lack of market but because of the due diligence and legal process for transferring ownership of real estate. We think that this is important as it underpins some of the assumptions in other parts of the guidelines.

Gustav Mahlerplein 62, 1082 MA Amsterdam, The Netherlands
+31 (0)20 235 86 00 | info@inrev.org | www.inrev.org

A considerable amount of work was undertaken by the real estate investment management industry following the global financial crisis. A good example is AREF, which commissioned a report from PwC, *Unlisted funds – Lessons from the crisis* (https://www.aref.org.uk/resource/report-for-aref-unlisted-funds---lessons-from-the-crisis-pdf.html) , a key focus of which was liquidity management. In addition, investors and investment managers are guided by INREV Guidelines on Liquidity which provide best practice recommendations (Liquidity - INREV Guidelines). Real estate funds therefore typically have a range of liquidity management tools, in many cases embedded in "business as usual" rather than safety valves that only release when there is already a problem.

There is an assumption that open-ended funds are highly liquid offering daily redemptions. This is almost never the case for real estate funds for institutional investor and is even relatively unusual in real estate funds available to retail investors, although daily redemptions can nevertheless still be managed effectively.

It should also be noted that, unlike many retail investors who invest a "nest egg" that they hope will grow in value over time, institutional investors such as pension funds and insurers invest for the long term in real estate in order to match the generally stable income flow derived from the assets with their long-term liabilities. They do not typically invest in open end real estate funds for liquidity, but rather because they are "evergreen" and institutional investors can invest for an indefinite period of time with stable income flows without needing to re-invest their capital every so-many years. Quarterly or even less frequent redemptions are normal in real estate funds for institutional investors, and in some cases redemption dates may be significantly longer, for example every five years.

Lock-up periods

We agree that during a lock-up period investors are typically not able to redeem their units or shares to the fund itself. However, it should be noted in the definition of lock-up periods, that the matching of trades may be possible if an investor can find another party to buy its shares or units in the fund. Some funds may also have soft lock-up periods during which investors may redeem, but at a significant discount to the prevailing redemption price, to protect remaining investors.

Matching subscriptions

It is important to stress the difference between redemptions that must be met by a sale of the underlying assets and a redemption that can be met through a matching subscription. It is only net redemptions that represent a liquidity risk. There is no liquidity mismatch if there is no need to sell anything. This is important in considering deferrals as a liquidity management tools.

Deferrals

The description of liquidity tools under Recommendation 3 and specifically footnote 27 misses the liquidity tool that is best suited to open-ended funds and is used most in practice by funds investing in real estate as an asset class. Real estate funds tend to allow a period to meet redemptions rather than a notice period before the redemption date. For example, a fund with quarterly redemptions may have two quarters following the initial

redemption date to meet redemptions, with a longer period if the redemption necessitates a sale of assets rather than matching the redemption with subscriptions. This is economically the same as delayed settlement but at the NAV prevailing just before the settlement date rather than the NAV at the date of the redemption request.

Delayed settlement paid out at the NAV at the original redemption price is highly risky in a falling market, creates first mover advantage and damages remaining investors. This was a clear lesson from the global financial crisis is not something that would typically be seen in a real estate fund.

Queuing change

In stressed circumstance, some real estate funds change queuing methodology and move to partial redemptions across the whole queue rather than chronological redemptions. This eliminates first mover advantage.

Recommendation 6: Considering and implementing a broad set of anti-dilution LMTs, quantity-based LMTs and other liquidity management measures *(Page 26 – 29)*

The responsible entity should consider and implement a broad set of liquidity management tools and measures to the extent allowed by local law and regulation for each OEF under its management, for both normal and stressed market conditions as part of robust liquidity management practices.

Q2. *Are there any other key considerations related to the availability and use of anti-dilution LMTs, quantity-based LMTs and other liquidity management measures under normal and stressed market conditions?*

Anti-dilution LMTs

Anti-dilution in real estate is more a reflection of the tax friction of buying assets than selling a market moving stake.

Quantity-based LMTs

As set out in our response to Question 1, deferred settlement increases first mover advantage. Deferred redemption reduces it, however, and it can be reduced further by choice of queuing rules.

Q3. *Are there any other LMTs or liquidity management measures commonly used by OEF managers?*

See our responses to Questions 1 and 2 regarding deferrals.

Recommendation 9 *(Pages 31-32)*

The responsible entity should integrate liquidity management in investment decisions.

"Responsible entities should only carry out transactions if the investment or technique/strategy employed does not compromise the ability of the CIS to comply with its liabilities, and its redemption obligations in the case of OEFs."

We don't agree with the wording above in the consultation. Provided investors are aware that the fund is investing in assets that are less liquid and the effect this may have on redemptions, then this may not be a factor. Funds shouldn't be forced into selling a large asset to meet a small redemption. They wouldn't want to have to sell a £10m asset to cover a £1m redemption, which would not be to the benefit of other investors in the fund. The fund manager would prefer to let redemptions build up before selling an asset or find a subscription against which to match the redemption.

It is also possible for real estate funds to consciously acquire much more liquid assets in active markets assets, which results in a significantly more liquid profile of the fund as the assets are very attractive from an investment perspective and can typically be sold quickly.

Recommendation 13: Effectively maintaining the liquidity risk management process with adequate and appropriate governance *(Pages 37-42)*

Responsible entities should have adequate and appropriate governance arrangements in place for their liquidity risk management processes, including clear decision-making processes for the use of liquidity management tools and other liquidity management measures in normal and stressed market conditions.

Q4. *Have the proposed changes covered all the essential elements regarding liquidity risk management governance arrangements in relation to the use of liquidity management tools and other liquidity management measures? Are they proportionate to the differing size and complexity of responsible entities' fund ranges?*

No comment

Q5. *Please describe any material factors of the liquidity risk management governance and oversight arrangements which have not been included.*

No comment

Recommendation 16 (Pages 44-46)

The responsible entity should ensure that liquidity risk of CIS it manages and its liquidity risk management process, including the availability and use of liquidity management tools and liquidity management measures, are effectively disclosed to investors and prospective investors.

Recommendation 17: Disclosures to investors regarding the use of anti-dilution LMTs, quantity-based LMTs and other liquidity management measures *(Pages 46 – 49)*

Q6. *What information can (and should) be disclosed to investors or the public, and within what timeframe should this information be disclosed to enhance transparency when responsible entities activate quantity-based LMTs or other liquidity management measures?*

The explanation under Recommendation 16 is very securities focussed. For more complex asset classes such as real estate, a "one-size-fits-all" approach is unlikely to be helpful and we feel that industry trade bodies are better able to provide guidance.

We agree with the proposed disclosure requirements under Recommendation 17. However, we find that the general feeling from the paper is that LMTs are something that only apply in exceptional circumstances. Most LMTs are used as part of the normal liquidity management of a fund and therefore should be disclosed to investors in the fund prospectus in the same way as other governance policies.

We agree that funds should be prepared for exceptional circumstances and should make investors aware, in the fund prospectus, that certain LMTs may be employed in these circumstances. However, the timeframe for notifying investors of how and when these will be employed will vary from fund to fund and the actual circumstance the fund is trying to protect the fund against. We don't believe there is a one-size-fits-all rule that can be set in regulation for this. For funds for institutional investors, the timing and form of investor communication is something that is agreed upfront with investors.

Other Proposed Revised Liquidity Recommendations

Q7. *Do you have any comments on any of the other Proposed Revised Liquidity Recommendations put forth in this document?*

Open-ended funds – redemption rights

There is a general assumption throughout the Recommendations that open-ended funds (OEFs) deal daily. As noted in our response to question 1, this is almost never the case for real estate funds for institutional investors and is even relatively unusual for real estate funds for retail investors. Even if redemptions are allowed daily, there will typically be significant notice or deferral periods.

Conclusion

We hope that our comments make a constructive contribution to the important issues raised in the IOSCO Consultation on Liquidity Risk Management for Collective Investment Schemes, primarily Open-Ended Funds. We remain available to provide any further information IOSCO would find helpful.

This INREV draft submission has been based on a model real estate industry response prepared by a working group representing industry associations: the Association of Real Estate Funds (AREF) and the European Association for Investors in Non-Listed Real Estate Vehicles (INREV).

For any inquiries, please contact:

Jeff Rupp

INREV Director of Public Affairs

jeff.rupp@inrev.org

+31 6 300 97 666

* INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide guidance, research and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe. INREV currently has approximately 500 members. Our member base includes institutional investors from around the globe including pension funds, insurance companies and sovereign wealth funds, as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into non-listed real estate vehicles in the UK and the rest of Europe. Our fund manager members manage more than 500 non-listed real estate investment funds, as well as joint ventures, club deals and separate accounts for institutional investors.