Bank of England Throws Weight Behind 'At Least' 180-Day Notice Period for Open-Ended Property Funds

FCA Final Policy Statement on Reforms to Open-Ended Funds to be Published Early in 2021

The Bank of England says "at least" a 180-day notice period would better address illiquidity concerns for open-ended property funds. (CoStar)

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The Bank of England's Financial Policy Committee has thrown its weight behind finance watchdog the Financial Conduct Authority's recent proposals to extend the

redemption notice periods for open-ended property funds to up to 180 days.

The Committee's latest Financial Stability Report said it felt the proposal "better aligned" with principles that it too had previously set out to address liquidity mismatch in open-ended funds.

The Financial Conduct Authority launched a fresh consultation on proposals for reform of open-ended property funds and in particular reducing the potential for harm to investors from the so-called liquidity mismatch in August.

The new proposed rules would require investors to give notice — potentially of up to 180 days — before their investment is redeemed.

At present investors in open-ended UK property funds — which were pretty much universally gated as the UK entered lockdown and valuers began to apply material valuation uncertainty clauses at the end of March — can buy and sell units on a frequent, often daily, basis. But the underlying property in which the funds invest cannot be bought and sold at the same frequency, creating the liquidity mismatch which the FCA is attempting to address.

Many funds have reopened since RICS' recommendation of a general lifting of the material valuation uncertainty clauses are applied in September.

When too many investors simultaneously redeem their investments, a fund manager may need to suspend dealings in

the units of the fund because of the liquidity mismatch between the fund units and the underlying property assets.

In addition, the illiquid nature of property also means that a reliable price is not always readily available, and in some market conditions, the fund units cannot be priced with confidence, leading to a need to suspend dealings in fund units.

In its latest report, the Bank of England's FPC said it considered that, from the perspective of financial stability, and given the illiquidity of property assets in stressed conditions, there would be benefits from extending notice periods to "at least as far as the range proposed in the consultation". The FPC also considered that further work was now needed by authorities, funds, platforms and investment managers acting in concert to ensure that pools of capital were able to be deployed into fund structures with longer notice periods.

It said it also recognised the importance of addressing liquidity mismatches in open-ended funds internationally, given the global nature of asset management and, within that, the UK’s role.

Under the UK legislation implementing the systemic risk buffer, or SRB, the FPC is required to review the framework used to guide the setting of the SRB every two years. It has decided no changes to the framework were necessary at this time, not least as buffer rates were currently maintained at the level set in December 2019 and would not be reassessed until December 2021. Any decision on buffer rates taken in December 2021 will take effect from January 2023 in line with the PRA’s policy. The FPC said it will keep this

judgment under review in light of any further information that became available during the COVID-19 shock.

The FPC also noted that the introduction of the Capital Requirements Directive V, or CRD V, as transposed in the UK by HM Treasury, would require the legal basis for the SRB to change from December 2020. As such, the FPC would replace the SRB framework with the other systemically important institutions, or O-SIIs, buffer framework.

It said, other than changing the name of the buffer, the framework would remain substantively unchanged, and the economic substance of the buffer would not be impacted.

Property fund suspensions have occurred with increasing frequency in recent years, including in the wake of the Brexit vote and in the current coronavirus pandemic — though it is important to stress that the redemptions and gating as the COVID-19 pandemic took hold were in response to the material valuation uncertainty caused, rather than a run on withdrawals, as happened after the EU referendum vote. The FCA has also introduced a regulation that a potential shift in the value of 20% of the assets in a fund should be noted and lead to a suspension, and that ruling came into effect on 30 September.

Fund suspensions exist to protect investors in exceptional circumstances, but the FCA said it has seen "repeated suspensions of these funds over recent years for liquidity reasons, which suggests that there may be wider problems". The FCA has said it is concerned that the current structure could disadvantage some investors because it incentivises investors to be the first to exit at times of stress.

"This can potentially harm those who remain if the fund suspends or assets are sold rapidly due to liquidity demands," the FCA said.

It said its proposed notice period would allow the manager to plan sales of property assets so that it could better meet redemptions that are requested. It would also enable greater efficiency within these products as fund managers would be able to allocate more of the fund to property and less to cash for unanticipated redemptions.

The FCA plans to publish a policy statement with the final rules "as soon as possible" in 2021. The consultation remained open to responses until 3 November.

John Forbes of John Forbes Consulting, a leading advisory expert on the topic, said at the time that a further consultation had already been flagged so the consultation was not a surprise.

Forbes said: "Notice periods is the simplest way of achieving a greater match between the liquidity of units and the liquidity of underlying assets, but is still problematic for many funds particularly if the platform architecture for retail investors cannot accommodate this.

"Some of the practical problems flagged in my 2017 AREF report on the behaviour of funds after the EU referendum are flagged in the report (eg investment by ISAs) but there is no solution as yet.

"It is disappointing that the FCA again want a one size fits all solution that does not give the retail investor greater choice,

but the consultation runs until November so time for the industry to respond."

Forbes pointed out that the FCA release could be misconstrued to imply the current fund suspensions during the COVID crisis are due to a liquidity mismatch when the funds presently had the liquidity but have been reacting to valuation uncertainty and the application of a specific FCA policy to apply in such circumstances.

"Notice periods do not help solve valuation uncertainty," Forbes said.

There have also been concerns that the rules could see property funds excluded from ISAs placing the asset class "off limits" to many private investors.

HMRC published its consultation with the FCA on the topic on 28 October. It proposes to allow existing investments in open-ended property funds to remain within the ISA whilst prohibiting the inclusion of "new" investments in such funds.

Forbes has responded to the consultation and contributed to responses from the Association of Real Estate Funds and Investment Property Forum describing the proposals as "woeful".

Forbes writes: "As the consultations states, “with the exception of Innovative Finance ISAs (whose intrinsic nature precludes liquidity), it is a longstanding requirement of the ISA rules that an account investor must be able to access any account investments and associated proceeds, or transfer them

to another ISA, within 30 days of making a withdrawal or transfer instruction.

"This is incompatible with 90 day notice periods and other possible liquidity tools such as deferrals, which have been proposed to the FCA in response to their consultation. In its consultation, HMRC states, 'this central tenet exists to ensure that investments are liquid, and that the investor can always access their funds in a reasonable timeframe — broadly reflecting ISA's original status as a retail investment scheme'. This seems an inherently flawed logic. Non-UCITS retail schemes are themselves retail investment schemes. The rules already allow redemptions at up to six monthly intervals, and the FCA consultation to which this HMRC consultation is in theory related, has a starting point that retail investment schemes can offer less liquidity where the underlying assets are property, and this is indeed the direction in which the FCA would like regulation to move. We do not see any reason why greater flexibility cannot be offered for stocks and shares ISAs where the underlying investments include illiquid investments, as is already the case for Innovative Finance ISAs."