Response by TISA to CP20/15: Liquidity mismatch in authorised open-ended property funds

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About TISA

The Investing and Saving Alliance (TISA) is a unique, rapidly growing membership organisation for UK financial services.

Our ambition is to improve the financial wellbeing of all UK consumers. We do this by focusing the convening the power of our broad industry membership base around the key issues to deliver practical solutions and devise innovative, evidence-based strategic proposals for government, policy makers and regulators that address major consumer issues.

TISA membership is representative of **all sectors of the financial services industry.** We have **over 200-member firms involved in the supply and distribution of savings, investment products and associated services**, including the UK's major investment managers, retail banks, online platforms, insurance companies, pension providers, distributors, building societies, wealth managers, third party administrators, Fintech businesses, financial consultants, financial advisers, industry infrastructure providers and stockbrokers.

As consumers, the financial services industry and the economy react to and recover from the effects of the pandemic, the importance of the three key pillars of work that TISA prioritises has never been more apparent:

- **Strategic policy initiatives that influence policymakers** regarding the financial wellbeing of UK consumers & thereby enhancing the environment within which the industry operates in the key areas of **consumer guidance, retirement planning, later lifetime lending, vulnerable customers, financial education, savings and investments**.
- TISA is recognised for the **expert technical support provided to members** on a range of operational and regulatory issues targeted at improving infrastructure and processes, establishing standards of good practice and the interpretation and implementation of new rules and regulations covering **MiFID II, CASS, ESG/RSI, operational resilience, Cyber Risk, SM&CR** and a range of other areas.
- **Digital transformation initiatives** that are driving ground-breaking innovation and the development of industry infrastructure for greater operational effectiveness and revenue promoting opportunity for firms. TISA has become a major industry delivery organisation for consumer focused, digital industry infrastructure initiatives – **TISAtech** (a digital marketplace that brings together financial institutions and FinTechs for greater collaboration and innovation) and **TURN** (TISA Universal Reporting Network – a digital platform providing a secure data exchange for financial services using blockchain technology) – alongside projects **Digital ID** and **Open Savings & Investment**. This reflects TISA's commitment to open standards and independent governance.

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Executive Summary

TISA welcomes the opportunity to respond to FCA's CP20/15: Liquidity mismatch in authorised open-ended property funds.

We understand the property suspensions that have taken place in recent years have rightly prompted the FCA to review these funds to ensure they are functioning as intended and in the consumers' best interest.

The existing mechanism to manage liquidity mismatch should only occur at times of severe stress, where a suspension is implemented for an appropriate period of time. This provides a flexible and logical approach which means that outside of exceptional scenarios, the funds continue to operate as intended.

A review of the last 10 years indicates that liquidity related suspensions which have occurred in recent times can typically be linked to two unprecedented events which have occurred, namely Brexit and the Coronavirus pandemic. Even given the scale of these, liquidity suspensions have not been a frequent occurrence.

The introduction of a notice period for all sales of these funds, irrespective of market conditions will place a significant impact on all of those involved in the value chain – consumer, advisers, platforms and property fund managers. Consumers who are invested in these funds will typically understand the nature of the longer-term investment that this asset class requires and will not be looking to move in and out of these on a regular basis. However, there will be personal and business operational reasons why redemptions should normally go through on the intended daily basis. Bringing in a potential 6-month delay will cause numerous problems and the inaccessibility issue would remove a whole cohort of consumers from being able to access this asset class and benefit from the diversification benefits it provides.

When you consider the transactions which platforms process for these funds, including fund switches and portfolio rebalancing, the complications which would arise from a notice period become highly challenging. Combined with the potential for fund manager withdrawals from this asset class may reduce the number of these that are available to consumers in the future. Furthermore, any form of financial planning involving these funds becomes challenging and subject to change, due to the uncertainty that the notice period creates. Advisers may look to move their clients away from these assets, which could place further pressure on fund managers to consider whether they continue to offer these funds.

We do not believe the proposals outlined in this paper are proportionate and are likely to cause more consumer and industry detriment than they seek to remove. They could potentially act as the stimulus for liquidity related suspensions. Fund managers do have the option to implement notice periods if they consider this is required. We believe that this, combined with the existing mechanism for fund suspensions and strong consumer communications, which have been enhanced through PS19/24 provides a proportionate framework for this asset class.

Question responses

Q1: Do you consider our proposals impact any groups with protected characteristics under the Equality Act 2010? Do you consider there are any issues which may be relevant to our obligations under the Equality Act (see paragraph 2.24)? If so, please provide details.

Whilst all groups would be subject to the same rules, we do believe that additional consideration should be given to individuals who are classed as 'vulnerable'. This group may find themselves impacted to a greater degree due to their circumstance.

Q2: Do you agree with our proposal to introduce notice periods for UK authorised property funds? If not, what alternative proposal would you have to address the structural liquidity mismatch?

Before answering this question, we need to consider what the problem is we are trying to address. The paper outlines the primary reasons being to provide more stability, reduce the situations where a fund suspension is required and to potentially increase returns due to the reduced need for significant cash holdings.

Fund suspensions should only occur during times where severe stress is being placed on the cash holdings within the fund, or where a material valuation uncertainty exists (however this suspension reason is out of scope for this CP). Looking back over the past 10 years market activity, liquidity linked fund suspensions have been almost entirely linked to Brexit and the associated uncertainty this causes. At that time, the shortest suspension lasted 7 days and the longest 4 months.

It is worth highlighting that Brexit was and remains an unprecedented event and of course, negatively impacted on nearly all asset classes to some degree. We are seeing the COVID pandemic lead to further suspensions, however, these are generally caused due to material valuation uncertainty, which could still occur whether a notice period exists or not.

Even considering the two major and exceptional events which have occurred in 2016 and 2020, we do not believe the fund suspensions which have occurred warrant the introduction of notice periods, which could have significant impact on consumer outcomes, reduce trust in the whole framework and creates a huge upheaval for industry. Outside of these exceptional events then suspensions are extremely rare in recent times, however we do acknowledge that consumers need to be aware of the nature of their investment and what the impact that times of extreme stress could create. This is the reason for the introduction of new regulations in the form of PS19/24, which should increase consumer understanding. These have not yet had time to take effect, however it would be prudent to assess the effectiveness of these before anything of such a significant nature and impact is implemented.

Reference is also made to 'first mover advantage' which can result in those who sell first receiving a better price than those who remain invested and sell later. The timings of trades and the associated profits or losses is the essence of market trading. As long as this is undertaken in a fair and legal way, then that is how a market operates, based on supply/demand and market sentiment. However, if this is undertaken in an unfair or illegal way, then this is where intervention is required. There are already sufficient rules in place on the operation of collective investment schemes to ensure that the unit price for all trades reflects a fair valuation and that those entering or leaving the fund do not do so at the expense of existing investors. We do not therefore, believe this aspect to be an issue.

Considering the above, we do not believe there is an inherent problem with open ended property funds. Funds can currently introduce notice periods on a voluntary basis through a 'change event', should they believe this would be an appropriate measure. The two exceptional scenarios covered above have shown that the existing mechanism of fund suspension at times of severe and unprecedented stress, serves its purpose and removes the liquidity mismatch for an appropriate period of time.

The introduction of a notice period operating permanently irrespective of market conditions creates a raft of issues and challenges for everyone who is involved. When you delve into the detail the list continues to grow, so this is by no means exhaustive but some of the problems we have identified as being caused by their introduction are below:

- Fundamentally, the uncertainty caused by not knowing the pricing details of a sale you undertake for up to 180 days creates consumer distrust and potential financial detriment, as the market may move significantly during the notice period. Whilst majority of investors will understand the long-term nature of the asset class and not be seeking to move in and out of these on a regular basis, there will be a need from both a business operations and personal perspective for these sales to go through on a daily basis. The uncertainties and time periods introduced with the concept of a notice period is likely to remove a whole cohort of investors from having the opportunity to invest.

- We may see some of these funds withdraw from this asset class. This could be the fund manager's decision or triggered by high volumes of sales before the notice period implementation date. A pending notice period could therefore act as a stimulus for fund suspensions. This then reduces the options available to retail investors, who wish to take advantage of the important benefits of diversification into this asset class.

- Given the nature of the asset, a notice period may not always solve the potential liquidity issue which may exist at times of severe stress. Property sales fall through, this could occur close to the expiry of the notification period. The fund manager may then be forced into making a quick sale at a discounted value or forced into selling other properties which are intended to remain within the fund. This will lead to a reduced redemption price and therefore consumer detriment. Conversely, a property may sell within a matter of weeks and the fund manager is then left holding the cash for potentially months before the proceeds can be released.

- CGT planning becomes complicated when you do not know the value of a redemption for potentially 180 days. Thresholds may be not utilised to the full or unintentionally exceeded with the associated penalties incurred.

- Fund switches become a protracted process. At what point is a contract note generated when the switch includes the sale of an open-ended property fund? It becomes challenging to even consider making any sort of switch involving the sale of one of these funds when the sale proceeds is an unknown – the buying side of the switch possibly becomes invalid if a notice period is introduced. Furthermore, personal circumstances change and what may have been appropriate at the point the switch is instigated may not be at the point the switch completes. Would providers need to pre-fund the switch and then reconcile at the point of completion?

- Portfolio rebalancing becomes highly complicated.

- Pension schemes will have to consider very carefully whether they will allow their members to access these funds. As an individual approaches retirement and potentially considers accessing their tax-free cash, they will need to ensure they are already moved away from these funds. If this is required unexpectedly and urgently, they will not be able to access their full entitlement immediately and details of the crystallisation will not be known until the notification period expires. This then means if they are close to their LTA and have other pension funds they wish to access, other pension schemes cannot undertake the LTA check accurately and these may need to be placed on hold or a tax penalty is incurred retrospectively. These funds would not be suitable for anyone in Drawdown. This then raises the question of whether a notice period means they are no longer appropriate for pension schemes members at all?

- Should notice periods be introduced, the lower level detail would need to be worked through from an operational perspective as these are currently not included within the CP e.g. is the notice period triggered intra-day or at the end of the day, is this calendar or working days? What may seem like small details will have an impact on pricing e.g.:

  If a daily pricing fund valuing at midday has a Notice Period of 7 calendar days and received a deal on Friday at 1PM, what VP would be used for the price applied to an investor's deal from the below options as either could currently be interpreted as being correct:

  1. The consumer would probably expect the VP to be the following Monday's VP and their view would remain the same irrespective of the time that the deal was received on the Friday. This is consistent with the view that the Notice period commences at the start of the calendar day that the deal was received.

  2. A more literal interpretation might be that the Notice Period ends at 1PM on the following Monday and the investor receives the price determined at the Tuesday VP.

- Should a 180-day notice period be introduced, funds would need to be daily priced to ensure the 185-day redemption deadline contained within COLL is met.

Q3: Do you agree that notice periods should be structured as described in this chapter? If not, why not and what alternative proposal would you suggest?

We do not agree that notice periods should be structured as outlined in the CP. Notice periods should be operated on a voluntary basis, as long as the consumer communications are clear in this regard.

Q4: The instrument sets out two alternative notice periods with lengths of 90 days or 180 days in COLL 6.2.22AR(2)(e). Which of these is the best? If neither, what alternative length would you propose and for what reason?

Given the varied nature of the asset class, any notice period could be too short or too long. Some sales could go through in days, others may take months, some will fall through and some will not. There is no appropriate notice period that can be applied across the board. Funds should determine whether a notice period is required and if so, determine the length of that period.

Q5: Do you agree with our proposal regarding the interaction of notice periods and suspensions? If not, what alternative approach would you propose and why?

We agree with this approach where a fund chooses to implement a notice period.

Q6: Do you agree that it is appropriate for FIIA rules to continue to apply to authorised property funds that operate notice periods?

Yes, we do not see the need for these rules to be amended.

Q7: Do you agree that property fund NURS currently dealing no more frequently than monthly should not be classed as FPIPs, and so would not need to operate notice periods? Do you agree that all other property fund NURS dealing at monthly or quarterly intervals (whether existing funds moving to such dealing arrangements or newly authorised funds) should be classed as FPIPs and be required to operate notice periods?

It would be prudent and logical to assess the target market and characteristics of all relevant funds to determine whether it is appropriate to implement a notice period or not, given the huge impact this would have for all parties concerned. Given our response to the questions above, we do not believe it would be appropriate to implement these for any of the funds identified at present.

We also struggle to see the logic in proposing an exemption for those funds dealing no more frequently than monthly, seeing as this does not preclude retail clients from investing in them and subject to the same perceived exposure risks as more frequently traded funds.

Q8: Do you agree that we should introduce a transitional rule to avoid the potential of a step increase in the capital requirements of SIPP providers? If not, what alternative proposal would you make?

We agree that the transitional rule should be implemented.

Q9: Do you agree that we have identified the other products and services that the change to notice periods would materially impact? If not, what other impacts should we consider?

There is a wider impact to the pensions market and in particular Drawdown and those in accumulation above minimum retirement age, where these funds would not be appropriate. We believe further work should be undertaken in this area.

Individual members will go into further detail in this area, however we believe having spoken to our membership that the implementation costs will be significantly higher than estimated within this CP.

Q10: What transitional arrangements do you think will be needed to implement the proposals in this paper? How quickly can they be brought into effect?

Given the nature of the proposals and those impacted in the value chain, this is a challenging area to provide a timeline to. Providers who currently administer these funds will want to wait and see what the impact will be before committing to any significant system change. If the number of these funds are reduced due to the perceived impact of the proposals or the market activity created through the introduction of notice periods, then this will be a factor in their decision making.

Given the challenging issues that will be faced, some of which we have outlined in this paper, we believe an implementation timeline of no less than 24 months is required.

Q11: Do you agree that the proposals in this paper for notice periods are preferable to placing other types of restrictions on funds that offer frequent dealing while investing in property assets (for example preventing them from future marketing to retail clients)? If not, what do you suggest?

As stated, we do not believe these proposals or other restrictions are required, based on historic market activity. The suspension mechanism in place provides a flexible approach to manage the liquidity mismatch in times of severe stress. It is, however, vitally important that consumers are aware of the potential consequences of such market activity and we welcome the rules set out in PS19/24.

Q12: Do you think that other types of fund should be permitted to operate notice periods? If so, please explain which other funds and why.

Any fund should be permitted to operate a notice period if this improves consumer outcomes and is clearly communicated.

Q13: Do you have any views on what further steps the FCA should take to accommodate long-term capital structures?

We support the Government views on encouraging long-term capital structures, where this diversification can help improve overall fund stability, returns and consumer outcomes.

Q14: Do you consider that there are any amendments to the fund rules (or other rules) which we should make to facilitate the development of a secondary market in units in property funds?

We do not believe that a secondary market in property funds would work for the benefit of the consumer. As buyers can access these funds straight away, the secondary market would only be of interest to those looking to purchase these at a discount i.e. take advantage of consumers who are experiencing the delay in realising the sale of their asset(s).