Privately Placed Funds in Korea: Risk Assessment and Future Directions

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Recent consecutive redemption suspensions of open-ended privately placed funds in Korea illustrate how operational and liquidity risks innate in those funds evolve into a debacle. Since the global financial crisis, authorities in the US and Europe have introduced regulations to manage operational and systemic risks inherent in privately placed funds. More recently, there has been regulatory discussions to effectively prevent the liquidity risk of open-ended funds for the purpose of the fair treatment of investors and the stability of financial system. In line with such regulatory trends, it's necessary that Korea's financial authorities carry out a thorough assessment on the risks inherent in privately placed funds, and improve the relevant regulatory framework. Regardless of such a move, it's also important for Korea's asset management industry to bolster their capabilities by enhancing their own risk management organization and framework, internal controls and compliance standards, and liquidity risk management process, which could help the industry regain investor confidence.

One of the most notable post-crisis trends in Korea's asset management industry is the rapid growth of privately placed funds. Although privately placed funds or private funds stood at KRW 127 trillion, half in size of publicly placed funds or public funds as of 2008, they grew to KRW 412 trillion in 2009, well above the public funds (KRW 237 trillion). Alongside with the growth, Korea's hedge fund market has ballooned from a mere KRW 150 billion as of the end of 2011 to KRW 34 trillion as of the end of 2019. The 2015 regulatory reform on private funds

⁎ All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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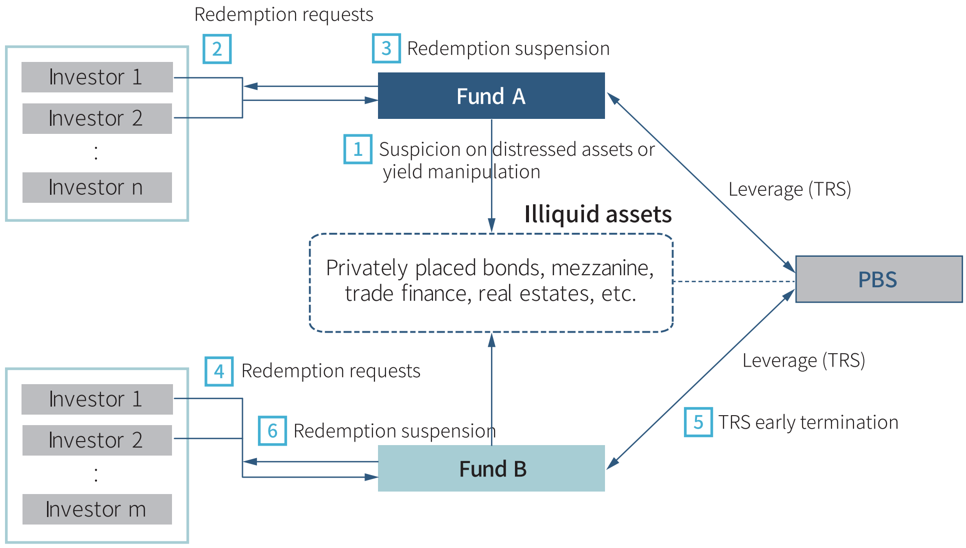
facilitated the rapid growth, especially in 'professional investment type' private funds including hedge funds. On top of that, new investments concentrated in some types of hedge funds such as 'bond-type', 'repo-type', 'Kosdaq venture-type', which further accelerated the growth in this segment. However, recent consecutive redemption suspensions by Lime Asset Management and AlpenRoute Asset Management not only put a brake on the growth trends in Korea's private funds but also seriously undermined investors' confidence.

In terms of risk management, a series of recent redemption suspensions by open-ended private funds concisely shows the process of how the risks inherent in those funds evolve into a debacle, which is illustrated in Figure 1 as an example. It starts from a suspicion about distressed underlying assets or an alleged manipulation of returns with regard to a hypothetical open-ended fund A that invests in illiquid assets like privately placed bonds, and mezzanine securities (step 1). This then triggers investors to request a redemption with concerns about investment losses (step 2). Upon the redemption request, the manager of fund A has no option but to suspend the redemption because he cannot fulfil the request due to asset devaluation, malfeasance, or any other reasons (step 3). This is similar to what happened to Lime Asset Management's KRW 1.7 trillion funds investing in privately place bonds, mezzanine securities, and trade finance. Investors in open-ended fund B—investing in assets similar to fund A—also request a redemption with concerns about losses (step 4). Meanwhile, the securities firm that provided leverage to fund A as a prime brokerage service (PBS) suffers losses from fund A's distress and redemption suspension. For the sake of risk management, the securities firm could decide to terminate the total return swap (TRS) agreement with fund B earlier than expected (step 5). This might trigger fund B to suspend the redemption although there's no asset distress fund A experienced (6), which is similar to the redemption suspension by AlpenRoute Asset management whose size is about KRW 110.8 billion.

Figure 1. Example of an Open-ended Fund's Liquidity Risk



Recent redemption suspension cases clearly demonstrate how liquidity risks arise and spread in an open-ended private fund using leverage to invest in illiquid assets. Also notable is the problem arising from those funds' distribution as well as operational risk, e.g., manipulation of returns, misuse of fund proceeds, etc. in the case of Lime Asset Management.1) In this regard, this article overviews the private fund regulation that has been bolstered in the US and Europe in the post-crisis era and recent discussions on the liquidity risk of open-ended funds. Based on that, this article discusses how to manage the risks of private funds recently at issue in Korea.

Post-crisis regulation on privately placed funds

In general, private funds target professional or qualified investors who are financially literate and capable of properly taking investment risks. Due to the almost nonexistent need for investor protection, private funds used to be loosely or not regulated in the Europe and the US in the pre-crisis era. After the global financial crisis, however, regulations have been introduced because of the possibility that private funds, especially large-scale private funds, might act as a vehicle to transfer systemic risk.

1) Another area for caution is that since 2017 more and more hedge funds have directly participated in the repo market for financing, which is increasing the linkage between the hedge fund and short-term money markets.

For example, the US mandates the registration of private fund managers managing over $150 million with the Securities and Exchange Commission (SEC), whereas Europe has enacted the Alternative Investment Fund Managers (AIFM) Directive with the aim to regulate private funds and its managers. Both the US and Europe have established a framework that enables to detect systemic risk in advance, by requiring all private fund managers to report their risk positions and to provide relevant information. In addition, they emphasize the fiduciary duty and stipulate the organizational requirements on the risk management process and internal controls system in order to prevent operational risk and conflicts of interests. However, the US and Europe do not impose any explicit investment restrictions on private funds, taking into account the nature of those funds.

Table 1. Key Features of Regulation on Private Funds in the US and Europe

Category	Details
Regulatory Objectives	· Regulate large-scale asset managers for managing systemic risk · Focus on mandatory risk reporting and information provision · Enhance early detection of potential systemic risk
Entry Regulation	· Focus on (large-scale) asset managers' qualifications · Comprehensive registration/authorization units · Low capital requirements
Prudential Regulation	· Regulation to prevent systemic and operational risks · Low level of financial prudential requirements · Focus on fiduciary duty, organization requirements on internal controls & risk management system, and operational principles
Investment Regulation	· No explicit restrictions on investment management

Note: Summary based on Shin et al. (2015)[2)]

Discussions and regulation on the liquidity risk of open-ended funds

With the dramatic increase in open-ended funds investing in illiquid assets in the post-crisis era, international organizations such as the FSB, IOSCO, IMF, etc. have raised the need to manage liquidity risks of those funds.[3)] For example, when an open-ended fund mainly investing in illiquid assets faces significant redemption requests, the fund manager has no option but

2) Shin, Kwon, Kim, Lee & Chun (2015), Global Financial Regulatory Trends and Future Direction of Korea's Financial Regulatory Reform, Korea Capital Market Institute Research Series 15-02.

3) Liquidity risk here means the risk that the fund cannot meet the investors' redemption requests without significant dilution of remaining investors' interests or discount of its asset value because it does not have enough cash or liquid assets. Behind the issue are two post-crisis trends: The persistent growth of the fund industry, and the increase in alternative investments in the low interest rate era.

to sell fund assets at discount to respond to the requests, although there is no asset distress. This in turn leads to a fall in the fund's asset value, which could spark concerns about losses among investors, and even further redemption requests. Furthermore, when the fund defers or suspends the redemption due to its inability for the request, liquidity risk then spreads to other funds or fund managers, imposing an adverse impact on the relevant asset markets as well as financial institutions, which could ultimately undermine the stability of the financial system. Certainly, such a liquidity risk could be severe particularly in the case of distressed underlying assets, non-transparent fund management, or a high level of leverage. This is why IOSCO recommends that an open-ended fund be equipped with an effective liquidity management process for the purpose of the fair treatment of investors and financial market stability.

Table 2. IOSCO Recommendations on Liquidity Risk

Category	IOSCO Policy Recommendations
CIS Design Process	· Devise an efficient liquidity risk management process · Set appropriate internal definitions and thresholds for the CIS's liquidity · Determine a suitable dealing frequency for units in the CIS · Dealing arrangements appropriate for its investment strategies and underlying assets
Liquidity Management Practices	· Consider liquidity aspects related to its proposed distribution channels · Ensure the access to, or effectively estimate, relevant information · Disclosure to investors on the liquidity risk and its liquidity risk management process
Day-to day Liquidity Management	· Strong and effective governance to support liquidity risk management process · Effective performance and maintenance of its liquidity management process · Regularly assess the liquidity of the assets held in the portfolio · Integrate liquidity management in investment decisions · Facilitate the ability to identify an emerging liquidity shortage before it occurs · Incorporate relevant data and factors into its liquidity risk management process · Conduct ongoing liquidity assessments in different scenarios (including stress testing) · Appropriate records keeping and relevant disclosures
Contingency Planning	· Establish a contingency plan and carry out periodic tests · Consider the implementation of additional liquidity management tools

Note: Summary based on policy recommendations in IOSCO (2018)[4)]

Table 2 shows IOSCO policy recommendations, which can be summarized as follows. First, fund managers need to perceive liquidity risk as one of major investment risks, and come up with an internal organization or risk management framework to manage the risk effectively. Second, liquidity risk should be managed from the fund design phase, by setting up redemption

4) IOSCO, 2018, Recommendations for Liquidity Risk Management for Collective Investment Schemes, Final Report.

policies and liquidity management tools appropriate to the fund's nature, and by implementing ongoing monitoring and stress tests. Third, given the regulatory objectives of fair treatment of investors and systemic risks management, it's desirable to establish a proper framework to report to the relevant authorities and disclose information to investors. In short, a manager of an open-ended fund should establish an organizational framework and proper liquidity management process to assess and manage the liquidity risk, and this should be properly reported and disclosed to the relevant authorities and investors. Since IOSCO policy recommendations were released, financial authorities in Australia, Hong Kong, and Singapore have adopted regulations requiring an open-ended fund to establish the liquidity risk management system, conduct regular liquidity stress testing, and strengthen disclosure to investors.[5)]

Liquidity risk regulations can also be found in the EU AIFM Directive that regulates private funds. The AIFM Directive presents requirements on how to manage liquidity risk from the systemic risk perspective in detail. For example, private fund managers (AIFMs) should have functionally and hierarchically separate functions of risk management from the operating units to identify and assess every risk associated to investment strategies, and come up with a proper risk management systems to identify, measure, manage and monitor appropriately all risks.[6)] The AIFM Directive also sets forth other details—appropriate liquidity management system for an open-ended fund, maintaining and monitoring a certain level of liquidity, regular stress testing (at least once per year), reporting and disclosure requirements, etc.[7)]

In the UK, the FCA has adopted new rules to regulate the liquidity risk of funds that invest in inherently illiquid assets since September 2019.[8)] These rules supplement the liquidity risk regulation in the AIFM Directive and are applied to the open-ended non-UCITS retail scheme (NURS) that invests in inherently illiquid assets. Details are as follows. First of all, it requires a fund manager to suspend dealing in units if material uncertainty applies to the value of

5) For details, please refer to the following documents: ASIC (Australia), 2017, Regulatory Guide 259: Risk management systems of responsible entities; SFC (Hong Kong), 2016, Circular to management companies of SFC-authorized funds on liquidity risk management; MAS (Singapore), 2018, Guidelines on Liquidity Risk Management Practices for Fund Management Companies. Taking into account international discussions on the liquidity risk of open-ended funds, the US SEC adopted the liquidity risk management program (22e-4 rule) for mutual funds, open-ended public funds in the US in October 2016.

6) Article 15, AIFM Directive.

7) Article 16, AIFM Directive. Under the article, information that is regarded as relevant to liquidity risk should be disclosed to investors (Article 23, AIFM Directive).

8) Discussions on these rules have started because dealing in a number of open-ended retail property funds was temporarily suspended right after the 2016 Brexit referendum.

immovable that constitutes more than 20% of scheme property. But a fund manager may continue to deal upon the consent of the depository if they have reasonable basis for determining that it is not in the best interests of investors to suspend. Also, the UK FCA requires depositaries to assess regularly the liquidity risk and devise procedures for overseeing the liquidity management by the fund manager. In addition, a fund manager is required to establish contingency plans for exceptional circumstances with regard to liquidity management, and disclose these in each fund's prospectus. Lastly, the FCA requires a fund manager to inform retail investors of the fund's potential liquidity risk by including a standard warning in financial promotions.

Table 3. Liquidity Risk Regulation on NURS in UK

Category	Details
Target	· Non-UCITS retail open-ended funds that invest in inherently illiquid assets
Mandatory Suspensions	· Mandatory suspensions due to material uncertainty on the valuation · Trading may continue upon the consent of the depositary with the reasonable basis that the suspension is against the best interest of investors
Liquidity Risk Management	· Implement and maintain an adequate liquidity contingency plan · Requirements on rapid sales and use of price reductions · Depositary oversight of liquidity management
Disclosure Requirements	· Disclosure of liquidity risk in the prospectus · Include a standard risk warning in the KIID and prospectus

Note: Summary based on FCA (2019)[9)]

Implications and future directions

The above discussions show that the US and Europe have strengthened the regulation to manage systemic and operational risks that could potentially arise from private funds since the global financial crisis. In particular, it is clear that the liquidity risk of open-ended public and private funds has become one of the major regulatory issues internationally. Hence, financial authorities need to assess the risks inherent in private funds in Korea and improve the current regulatory framework.

For example, it is necessary to enhance the requirements on risk management system and internal controls for the private funds as the liquidity risk and operational risk of open-ended private funds have occurred in Korea. In view of IOSCO recommendations, it is desirable to explicitly impose requirements on open-ended private funds such as establishing the liquidity

9) FCA, 2019, Illiquid assets and open-ended funds and feedback to Consultation Paper, CP 18/27, PS 19/24.

risk management process, conducting regular liquidity stress tests, and reporting relevant risks. Also necessary is a thorough review on a range of additional liquidity management tools available for fund managers, including when to use them and how to disclose such information to investors. In addition to basic information on private funds, financial authorities should collect and monitor data necessary to manage systemic and operational risks such as leverage, risk exposure, illiquid asset position, results of liquidity stress tests, etc. It is required to strengthen supervision and punishment for the misconduct as well.

As reputation is critical in the nature of asset management, the industry should bolster their capabilities by reshaping their own risk management organization and system, internal controls and compliance standards regardless of regulatory mandates, which could help regain investor confidence. Any fund manager who wants to run an open-ended private fund should be equipped with additional liquidity management tools and redemption policies suitable for the fund’s investment strategies, investor base and underlying assets, and properly manage the liquidity risk within a permissible level. As one of the main pillars in the hedge fund market, prime brokers need to contribute to the market development by strengthening their risk management functions. Lastly, distributors of private funds should review and enhance their distribution process to get rid of room for mis-selling or incomplete sales as much as possible considering the diversity of investors.