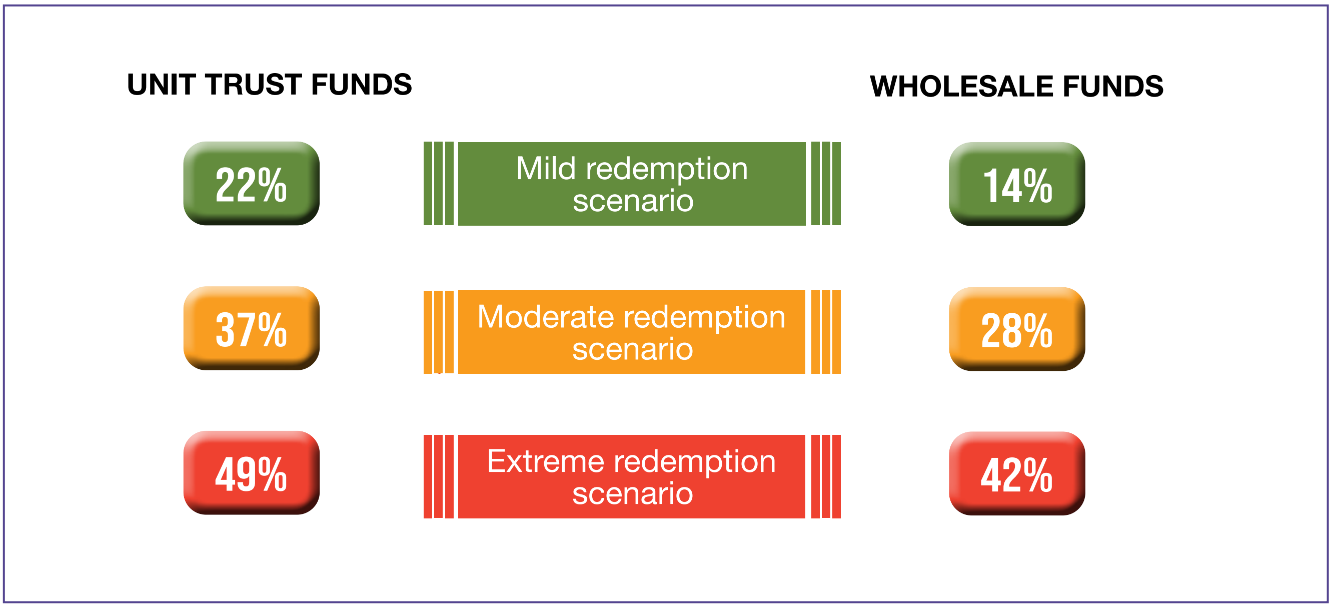
ASSESSING LIQUIDITY RISK IN INVESTMENT FUNDS

Asset liquidity remains critical in mitigating adverse impacts from potentially large redemption pressures, which are common during periods of unfavourable market conditions. Recognising the need for an industry-wide assessment, the SC developed and conducted a series of macro stress tests on unit trust and wholesale funds (collectively referred to as investment funds). This aligns with the International Organization of Securities Commissions'[1] (IOSCO) focus on assessing the liquidity characteristics of assets in relation to their anticipated redemption flows in stressed market conditions.

STRESS TEST SCENARIOS AND METHODOLOGY

The macro stress test was conducted based on plausible tail scenarios, which were derived from historical redemption data to simulate mild, moderate, and extreme redemption pressures (Figure 1). Several assumptions were applied in developing the scenarios, including the expectation that the initial redemption shock would prompt further redemptions by other unitholders. Additionally, individual investment funds were required to maintain liquidity buffers of at least 10% in all asset classes in anticipation of future redemptions by unitholders. Effectively, funds incapable of reserving sufficient buffers for redemption are considered illiquid. The stress test exercise also assumed that neither the regulator nor the trustee would intervene in terms of liquidity management practices.

FIGURE 1
Stress test scenarios based on redemption of NAV



Source: The SC.

[1] *Final Report: Recommendations for Liquidity Risk Management for Collective Investment Schemes*. The Board of the IOSCO, IOSCO, 2018.