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GUIDANCE NOTES ON LIQUIDITY RISK MANAGEMENT FOR FUND MANAGEMENT AND UNIT TRUST MANAGEMENT COMPANIES

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CONTENTS

Page

PART I Introduction and Overview 1

PART II Guidance Notes on Liquidity Risk Management 3

Introduction 3

Governance 3

Initial Product Design and Disclosure 5

Ongoing LRM 6

Stress Testing 8

LRM Tools and Contingency Plans 10

PART I

INTRODUCTION AND OVERVIEW

Background and Purpose

1.1 The purpose of these *Guidance Notes on Liquidity Risk Management for Fund Management and Unit Trust Management Companies* is to provide guidance on sound liquidity risk management (LRM) practices in managing open-ended funds (Funds) in line with recommendations made by International Organization of Securities Commissions (IOSCO) in February 2018[1].

1.2 The Securities Commission Malaysia (SC) has conducted a LRM thematic review on a number of Fund Management Companies and Unit Trust Management Companies, and identified certain good practices for LRM. Based on the review and IOSCO's recommendations, these Guidance Notes are issued as a guide in the development of effective liquidity risk management frameworks in managing Funds. These Guidance Notes should be read together with the recommendations of IOSCO, where relevant.

Applicability

1.3 These Guidance Notes are applicable to the following entities in relation to managing liquidity risk of Funds:

(a) Fund Management Companies licensed by the SC for fund management in relation to portfolio management pursuant to Paragraph 2.05(1) of the *Licensing Handbook*; and

(b) Unit Trust Management Companies approved pursuant to Section 289 of the *Capital Markets and Services Act 2007*.

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[1] IOSCO first published a report on the *Principles of Liquidity Risk Management for Collective Investment Schemes* (Liquidity Report) in March 2013.(https://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf). Following recommendations from Financial Stability Board in January 2017, IOSCO has reaffirmed and enhanced the 2013 Liquidity Report, and has issued its *Recommendations for Liquidity Risk Management for Collective Investment Schemes* (2018 Liquidity Recommendations) in February 2018. (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf).

For the purpose of these Guidance Notes, these entities will be referred to as 'Management Company'.

1.4 The applicability of these Guidance Notes should be determined based on the Management Company's role in managing the Funds throughout their life cycle. While a Management Company may delegate fund management function to another fund management company, the responsibility to monitor and manage the overall liquidity profile of the Fund still remains with the Management Company that incepted the Fund.

1.5 The Management Company should consider how best to apply and adopt the LRM practices set out in these Guidance Notes, taking into account the size, scale and complexity of its business models and the profile of the Funds managed.

PART II

GUIDANCE NOTES ON LIQUIDITY RISK MANAGEMENT

Introduction

2.1 An effective LRM of a Fund is important to mitigate potential mismatches between the liquidity of the Fund's underlying assets and the redemption terms under which the Fund is offered to investors. Liquidity mismatch could result in adverse outcomes for the Fund and its investors such as the inability to meet redemption requests, the Fund having to sell the most liquid assets to meet redemption requests leaving the Fund with illiquid assets and at the same time unduly changing the risk profile of the Fund. The remaining investors would then be unfairly bearing the cost of asset liquidation and subsequent portfolio rebalancing. As such, an effective LRM not only ensures that the Management Company is able to meet redemption requests in an orderly manner, but also seeks to ensure the fair treatment of all investors, including those who remain invested in the Fund.

Governance

2.2 The Management Company should establish effective LRM practices for the Funds that it manages.

2.3 These should be supported by effective governance structures as outlined below:

(a) ***Independent oversight of LRM function, ongoing monitoring and management of the liquidity risk by board and/or senior management***: The board members and senior management involved in the LRM oversight functions should be independent from the day-to-day investment function. There should be adequate review, escalation and remediation process in place.

(b) ***LRM function to monitor the implementation of the LRM Policies and Procedures (P&Ps)***: Ideally, this function should be independent from the investment team that manages the Funds.

(c) ***Comprehensive LRM P&Ps***: The P&Ps should cover the entire life cycle of the Funds, be reviewed regularly and updated as and when there are material changes. Examples of material changes are investments into new asset class, substantial change of liquidity profile of a Fund, etc.

Good Practices to Paragraph 2.2 and 2.3

Examples:

(i) Management Company A has established a Risk Management Framework where liquidity risk is a component.

The LRM function is carried out by the Risk Management Department (RMD) and is independent from the investment function. Both the risk management and investment functions work closely on the Funds' liquidity risks. Liquidity risk issues including results of stress testing and policy matters are escalated to the Risk Management Committee (RMC) and Investment Committee (IC) periodically for deliberation and decision.

The RMC and/or IC held meetings on a regular basis, and as and when required during periods of market stress.

(ii) Management Company B (a mid-/small-sized Management Company) has lean operations with established risk management P&Ps. The day-to-day LRM is carried out by a designated staff for risk management function. The staff is independent from the investment function and reports directly to the CEO and/or Board.

Initial Product Design and Disclosure

2.4 The evaluation of liquidity risks of a Fund should begin at the product design stage and set the foundation for effective LRM framework.

2.5 Various functions within the Management Company, e.g. product development, investment management, operations and marketing are encouraged to be involved in the initial product design stage to provide input on the LRM strategy for the Fund.

2.6 When finalising the key product features, the Management Company should address liquidity risks including but not limited to the following areas:

(a) tenure of the fund (e.g. open-ended, close-ended, etc.);

(b) fund type (e.g. unit trust funds, wholesale funds, etc.);

(c) investment management arrangement (e.g. in-house, delegation, feeder, etc.);

(d) liquidity profile of target market investors (e.g. retail, high net worth, corporate bodies, etc.);

(e) liquidity profile of distribution channel (e.g. redemption pattern from Institutional Unit Trust Scheme Adviser (IUTA), Corporate Unit Trust Scheme Adviser (CUTA), Unit Trust Scheme Consultant (UTC), etc.);

(f) liquidity profile of underlying investment instruments under different market conditions (e.g. equity, money market, fixed income, derivatives, structured products, warrants, etc.); and

(g) redemption policy (e.g. redemption tools, redemption frequency, etc.).

2.7 The RMD plays a pertinent role during initial product design stage, in assessing the impact of key product features on liquidity risk and mitigating plan. Independent risk assessment by the RMD should be part of the product proposal paper for sign-off by senior management, before tabling it for the Board’s approval.

Good practices to Paragraphs 2.4 to 2.7
Example: Management Company C has established a Product Development P&P to incorporate recommendations in Paragraphs 2.4 to 2.7 above. The P&P is reviewed periodically, updated and tabled to its Board for approval.

2.8 Adequate disclosures in the product offering documents enable investors to make informed decisions as to whether their risk appetites match the product's liquidity risk profile. As such, the Management Company should include clear and simple-to-understand disclosures in the product offering documents to explain its general approach towards liquidity risk which includes:

(a) significance and potential impact of liquidity risk on the products and its investors;

(b) a summary of the LRM process to mitigate liquidity risk; and

(c) explanation on LRM redemption policy or exceptional measures that could affect the redemption rights of its investors.

Ongoing LRM

2.9 A Management Company is expected to monitor and manage the liquidity risk of a product throughout its life cycle, which includes ongoing monitoring of product features, investors' profile and redemption patterns.

2.10 The ongoing monitoring is critical to facilitate the Management Company's ability to anticipate or identify an emerging liquidity shortage before it occurs, and take appropriate steps to minimise disruption or detriment to investors. Below are some of the considerations that are relevant in relation to ongoing monitoring and management of liquidity risk:

(a) Review of investors' historical redemption patterns and expected future liquidity demands of the product at different stages of its life cycle under varying market conditions;

Good practices to Paragraph 2.9 and 2.10(a):

Examples:

(i) For its feeder fund, Management Company A monitors the fund's NAV and Units in Circulation (UIC) against the target fund size. Management Company A also considers its target fund's redemption terms when designing the feeder fund's features.

(ii) Management Company B sets investors' concentration threshold and monitors the Fund's concentration to investors.

(iii) Management Company C actively engages with key investors and enforces redemption arrangement for investors above the threshold i.e. advance redemption notice so that the company is aware if investors intend to make any large redemption. This enables Management Company C to assess the liquidity implications on its product and take appropriate steps to manage the redemption in an orderly manner.

(iv) Management Company D has difficulty in having direct access to investors' profile information due to its Fund's distribution arrangements (e.g. nominee structure). Nevertheless, Management Company D has taken reasonable steps to obtain statistics on investors' profile to the extent practicable when performing the liquidity assessment.

(b) Integrate liquidity as one of the relevant considerations in the Management Company's investment management decisions; and

Good practices to Paragraph 2.10 (b):

Management Company A develops a liquidity risk dashboard using appropriate liquidity metrics or indicators in varied market conditions, such as:

(i) the number of days and cost to liquidate assets; and

(ii) redemption coverage ratio (i.e. liquid asset / redemption).

(c) Establish appropriate procedures to alert staff members responsible for LRM and to provide them with adequate time to take appropriate action to minimise the impact.

Stress Testing

2.11 Management Company should perform liquidity stress testing on its Funds on an ongoing basis to assess the impact of market disruptions on the liquidity and redemption levels of the Funds. Stress testing should enable the Management Company to pre-empt an emerging liquidity shortage before it occurs and make informed decisions in respect of Funds' asset composition, LRM and contingency planning.

2.12 Liquidity stress testing should be conducted on all Funds. Where stress testing is not conducted on a particular Fund, Management Company should document the rationale and such decision should be reviewed and approved by the Board and/or senior management on a regular basis.

2.13 Management Company should design its stress testing based on backward-looking historical scenarios and forward looking hypothetical scenarios using multiple scenarios with deterioration of asset liquidity condition. Stress testing should also include a combination of stress factors (e.g. simultaneous increase in redemption and decrease in underlying asset liquidity).

2.14 Management Company should regularly conduct the following:

(a) Review, update and document stress testing scenarios and assumptions to take into account changes in size, investment strategy, nature and complexity of the underlying assets as well as investor profile of the Funds. These assumptions must be prudent, reasonable and justifiable;

(b) Perform stress testing at an appropriate frequency taking into consideration factors relevant to the specific Fund. Liquidity stress testing is expected to be conducted at least half yearly;

Good Practices to Paragraph 2.13 and 2.14 (a):

Liquidity risk usually results from significant redemptions or illiquid assets or a combination of both.

i. Significant redemption scenarios

a. Funds could experience redemptions that are more than the largest historical redemptions of similar Funds. Therefore, Management Company A adopts a more extreme scenario and performs stress testing based on a scenario where Funds experience redemption equal to a multiple of the largest historical redemption;

b. Management Company B experiences redemption by large unitholders whereby there is a unitholders concentration in a particular Fund. The nominee holding structure tends to reduce Management Company B's visibility over the investor profile of its Fund. As an alternative, Management Company B performs stress testing based on a scenario where all units sold through a particular IUTA are redeemed at the same time; and

c. Redemption behaviour based on investor profile. For instance, retail investors who invested directly in 'Fund A' historically exit faster than retail investors who invested in 'Fund A' through an IUTA, or large institutional investors are more likely to remain invested in 'Fund B' compared to smaller institutional investors, etc. Therefore, Management Company C implements such a scenario to model investor behaviour based on historical redemptions data and make certain assumptions on investors' behaviour.

ii. Illiquid assets/deterioration of liquidity condition

a. To account for deterioration of securities' liquidity conditions in different stress scenarios, Management Company D assigns varying participation rates based on historical average daily trading volume (ADTV) in its stress test model; and

b. As for investment instruments traded over-the-counter (OTC) such as fixed-income securities which lack reliable and transparent trading data, Management Company D uses a combination of quantitative (i.e. size, maturity, ratings, etc.) and qualitative (i.e. professional opinion of traders/fund managers, etc.) metrics to assess the liquidity profile of the securities.

2.15 The stress-test results should be adequately integrated into the Management Company's investment decision-making and risk management process throughout the Funds' life cycle.

LRM Tools and Contingency Plans

2.16 A Management Company should proactively consider LRM tools that will enable timely actions to be taken in the event of liquidity disruption or stress.

2.17 Protection of investors' interest should be the key consideration in the use of LRM tools and should always be prioritised over other factors, for example competition and reputational concerns. A Management Company should also ensure that when using these tools, the intended outcome should not stray from the investment strategy and portfolio profile.

2.18 Example of good practices in the usage of LRM tools to delay and/or limit redemption are found below.

Good Practices to Paragraph 2.16 and 2.17:

(i) As part of the liquidity management plan, Management Company A has agreed with its large investors that they will give notice in advance to Management Company A if they plan to make substantial redemptions of its Funds.

(ii) Management Company B has made the following disclosures in its Fund's offering documents:

- suspension of redemptions under exceptional circumstances; and
- deferring the processing of redemption requests on a pro-rata basis, to the next dealing day when a Fund faces huge redemptions, provided that certain criteria are met (i.e. redemption requests exceed the threshold / limit disclosed in the Fund's offering document).

2.19 Among the benefits of using LRM tools is improvement of investors' confidence in the management of the Funds, which is due to the reduced likelihood of redemption requests that cannot be met by Management Company in varied market conditions. As a result, this would minimise risk of a run on the Funds in a stressed market environment, which may considerably reduce the value of investments for remaining investors and possibly further disrupt the market.

2.20 To facilitate greater transparency, the offering documents should disclose to investors on the descriptions of the LRM tools put in place, explanations on the situations which may require the usage and potential impact of the tools on the Funds and investors.

2.21 A Management Company should proactively have in place and periodically test contingency plans with the aim to be used where necessary, and if it is being activated, can be exercised in a prompt and orderly manner. This may also include but not limited to situations whereby the Management Company has to secure a credit line to meet short-term bridging requirements.

2.22 A Management Company should ensure that its LRM policies are clearly documented and include the decision-making matrix for the activation of contingency plans and execution of applicable LRM tools as well as mitigating steps to be taken.