At a glance

Liquidity Risk Management for Funds

June 2020

Current Regulatory Focus

In light of the COVID-19 crisis, the SFC issued a circular in March 2020 reminding all fund managers, trustees and custodians of SFC-authorized funds to use appropriate liquidity risk management tools. This follows the August 2019 SFC circular to licensed corporations that highlighted deficiencies or inadequacies in fund managers' liquidity risk management practices in the following areas of focus:

- Overall liquidity risk management framework
- Stress testing
- Risk management reports
- Assessments of liquidity profiles of fund assets and liabilities
- Governance structure for risk management
- Documentation

In addition, the SFC revised the Fund Manager Code of Conduct, which sets out the conduct requirements for a Fund Manager that is responsible for the overall operation of a fund, whether this is a private fund or an SFC authorized fund, with regard to liquidity risk management. This came into effect on 17 November 2018. Given the current environment and increased regulatory focus, liquidity risk management is critical for the asset and wealth management industry in Hong Kong.

SFC Concerns

In a Compliance Bulletin published in January 2020, the SFC highlighted the following concerns over liquidity risk:

- Liquidity risk arises when there is a mismatch between a fund's assets and its liabilities with the risk running higher if the fund is concentrated in illiquid investments.
- Risk is even higher for funds with an open-ended structure, especially those with daily dealing arrangements, when investors hurry to redeem due to any hint of trouble or poor performance.
- The SFC advises that investors should be wary of investing in funds concentrated in hard-to-sell assets, particularly illiquid bonds issued by the same group, and funds with long or extendable redemption dates.

> *Fund managers should conduct stress tests and closely monitor the liquidity profiles of their fund portfolios throughout the entire life cycle of their funds," said Ms. Julia Leung, SFC's Deputy Chief Executive Officer and Executive Director of Intermediaries, 20 January 2020.*

Good Practices

The SFC identifies the following good practices for managing liquidity risk in its latest Compliance Bulletin:

- Establish effective liquidity risk management policies and procedures, with action plans to meet redemption requests under normal and stressed market conditions.
- Target investment diversification and regularly assess the liquidity profile of the fund's assets and liabilities, considering its investor profile and historical and expected redemption patterns.
- Ensure that the fund's dealing (subscription and redemption) arrangements are appropriate for its investment strategy and underlying assets throughout the entire product life cycle.
- Perform liquidity stress tests on an ongoing basis to assess the impact of severe adverse changes in market conditions as well as the fund manager's action plans and liquidity risk management tools.
- Intermediaries should also follow the guidance issued by the SFC in August 2019 on managing the liquidity risk of open-ended funds.

How PwC can help?

In practice, different liquidity risk management measures can be considered under different situations, e.g., asset class, availability of information, dealing cycle, trade frequency. We have the expertise to help you in the following areas:

- Review current risk policies and procedures for compliance with SFC requirements;
- Conduct a gap analysis of your risk management processes in place and advise over compliance with applicable regulatory requirements;
- Review and assess the current stress testing scenarios in place; and
- Provide practical advice and liquidity risk management solutions on your monitoring controls over liquidity risk.

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