Effective Liquidity Risk Management

in Managed Investment Schemes

2024

Key Takeaways

Financial Markets Authority (FMA) updated the Liquidity Risk Management Guide (LRM Guide) for Managers and Supervisors of Managed Investment Scheme (MIS).

The guide emphasises the importance of effective liquidity risk management (LRM) in meeting statutory duties and acting in the best interests of investors.

The recent increase in early withdrawals from KiwiSaver schemes may also lead to greater focus on LRM by the Financial Markets Authority (FMA) in their evaluation of Managers and Supervisors statutory duties.

Funds should consider formally reviewing their overall liquidity management with particular emphasis on improving the LRM frameworks, policies and procedures as well as regular stress testing and use of liquidity management tools.

Background

Following recent heightened market volatility during the COVID-19 pandemic and other geopolitical events, reports published by IOSCO (the International Organization of Securities Commissions) and the Financial Stability Board (FSB) highlighted greater potential for fund managers to improve their liquidity risk management in order to promote greater financial stability and good customer outcomes.

The FMA considered these recommendations and published updated guidance in April 2024. This built on their April 2020 practice guide that provided Managed Investment Schemes (MIS Managers) with details of good practices for liquidity management and stress testing

FMA's expectations of MIS Managers and Supervisors

The FMA expects that care, diligence and skill are properly utilized when developing and implementing policies, processes, and tools for managing liquidity risk effectively.

Furthermore, the FMA believes that effective and appropriate LRM is an important part of how Managers demonstrate meeting legal responsibilities. MIS Managers and Supervisors are expected to consider the LRM guide when designing, implementing and monitoring a robust liquidity risk management framework.

The FMA's focus

The key focus is to ensure Managers improve on the liquidity risk management guidelines in order to meet statutory duties and act in the best interest of investors.

Key improvements the FMA would like to see are:

- Better frameworks, policies and procedures covering LRM.
- More regular stress testing.
- More tailored liquidity management tools (LMTs) made available for use.

Effective Liquidity Risk Management

With increased regulatory focus on fund managers internationally including by the FSB and IOSCO, there has been greater scrutiny in open-ended fund's liquidity risk. Domestically, recent statistics on withdrawals in KiwiSaver schemes also put the spotlight on overall fund liquidity management.

The FMA's Liquidity Risk Management Guide (LRM Guide) is an important read for MIS Managers and Supervisors, to get a better understanding of minimum regulatory expectations. While these are recognised as guidelines, in the event of a liquidity stress we expect the FMA to scrutinise the fund's overall LRM framework.

Key features of an effective LRM

Governance and Infrastructure

- **Overarching framework and strategy**: thorough process for identifying and managing liquidity risk, including contingency planning, integrated into the overall risk management framework.
- **Governance**: inclusion of board and senior management approval, oversight and review.
- **Contingency plans**: Formal liquidity contingency plan (LCP) that clearly set out strategies for addressing shortfalls in emergency situations.

Fund managers to review integration of liquidity risk into governance frameworks and consider;

- **Strategy** – Clearly articulating liquidity strategy, tolerance and contingency planning.
- **Committees & Frameworks** – Incorporating and prioritising liquidity in overall risk frameworks.
- **Review** – Ensuring ongoing review to ascertain continual applicability of liquidity tools and frameworks.
- **Reporting & Oversight** – Developing robust, clear reporting to senior management including early warning indicators and testing of processes and controls framework.

Liquidity Risk Management Capabilities

- **Monitoring framework**: Appropriate monitoring and reporting on levels of liquidity and liquidity risk in the fund.
- **Liquidity management tools**: Range of appropriate LMTs readily available to deploy in specific circumstances.
- **Stress testing**: Stress testing framework for each scheme with appropriate governance and oversight, scenario testing and ongoing liquidity risk management.
- **Use of leverage to adjust risk/return**: Sound understanding of risks and impact for fund and broader financial system in the event of financial distress where leverage is used to adjust risk/return.
- **Record keeping, data and systems**: Appropriate LRM records, and reliable data and systems that support effective analysis and management of liquidity risk.

Appropriate Liquidity management tools should be developed and utilised with focus on;

- **Fund specific LMTs** – Ensuring LMTs consider liquidity profiles of specific funds in conjunction with overall LMTs that can be deployed.
- **Definitions** – Defining and categorising all LMTs. Conditions under which these are deployed should be assessed with consideration given to ensure equitable treatment of scheme participants.
- **Testing** – Ensuring all redemptions are monitored, tested and thresholds set to maintain fund liquidity in all events.

Stress testing framework should be developed for each scheme and consider;

- **Governance & Oversight** – Ensuring regular communication and follow-up of testing and results to committee and board.
- **Methodology** – Ensuring stress tests are clearly documented with appropriate assumptions and applicability to each specific fund and its characteristics.
- **Integration** – Developing tests and incorporating at all stages of product lifecycle with results integrated into overall LRM and LMTs.

Design, Disclosure and Communication

- **Product design**: Ensuring offered subscription and redemption terms are appropriate for investment strategy and product offering.
- **Disclosure and communication**: Sufficient information provided to investors to understand how the fund manages liquidity risk and how it may affect their investment. Proactive communication with investors.

Evaluation and Review

- **Evaluation and review**: Regular review of LRM practices to ensure ongoing suitability and inform areas for improvement.

How KPMG can help

Our experts can help you on your journey

KPMG understands the practical challenges of implementing effective liquidity risk management across various regulatory environments. We are well placed to support managed investment schemes in enhancing their liquidity risk management practices in order to better align with the FMA guidelines.

We have an in-depth understanding of the related Liquidity Risk Management guidelines, gained through carrying out a wide variety of prudential reviews.

Our credentials include working with the Reserve Bank on the liquidity thematic review as well as a broad range liquidity reviews across various financial institutions.

We have a team that can help with:

- developing a robust and achievable liquidity risk management framework,
- reviewing stress testing tools,
- development or review of liquidity risk models,
- optimising and enhancing data governance.

Contact us

Rajesh Megchiani

Partner, Risk Consulting
T: +64 9 363 3581
E: rmegchiani@kpmg.co.nz

Greg Scott

Director, Risk Consulting
T: +64 9 365 4064
E: gregscott@kpmg.co.nz

Chirag Patel

Senior Manager, Risk Consulting
T: +64 9 365 4098
E: cpatel5@kpmg.co.nz

kpmg.com/nz