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Dear Chief Executive

Liquidity Management Multi-Firm Review

As mentioned in our recent Asset Management Portfolio Letter, we have undertaken a multi-firm review of liquidity management by Authorised Fund Managers (AFMs). This letter sets out key findings. Alongside this letter we are also publishing the multi-firm review with detailed observations including a guide to good practice.

Please share this letter with your Board or equivalent.

We expect you to review your firm's liquidity management arrangements, consider the application of our findings in our review, and make any necessary enhancements.

Although this review focuses on AFMs, we expect all asset managers and managers of Alternative Investment Funds to consider the findings for their businesses.

Why we conducted this Multi Firm Review

It is important that fund redemptions operate in line with funds' terms and the way in which they are marketed. Additionally, investors should be able to redeem at an accurate price that reflects the value of their investment, ensuring fairness for both remaining and redeeming investors in the fund (Principle 6: *Customers' interests*). Management of liquidity is central to that, particularly during periods of market or redemption stress.

The regulatory framework imposes requirements on asset management firms to ensure they consider and manage fund liquidity. The specific requirements vary depending on the nature of your firm and fund, but all firms have an important role to play in ensuring good liquidity management, appropriate for the product offered.

In 2019, we wrote to UK AFM Boards asking firms to review their liquidity management arrangements against FCA good practice. We also made enhancements to our rules to require funds to suspend dealing in certain circumstances. In this new review we built on our earlier work.

There is also a significant body of work under way internationally on liquidity practices. A recent Financial Stability Board (FSB) report set out some good progress on liquidity management standards globally. We are an active member of the International Organization of Securities Commissions (IOSCO) which recently published its consultation report on implementing liquidity management tools. Our findings from this multi-firm review and previous supervisory work have informed our contributions to IOSCO.

One of the FCA's strategic areas of focus is to promote competition and positive change. By increasing standards of investor protection, this strengthens the UK's position in wholesale markets and helps encourage growth in the UK economy.

What we found

Some firms demonstrated very high standards in liquidity management. However, we found a wide disparity among firms in the quality of compliance with regulatory standards and depth of liquidity risk management expertise.

Most firms fell short in some aspects of their framework. A minority of firms had inadequate frameworks to manage liquidity risk effectively and we have provided detailed feedback to inform remedial plans to address those.

Most firms had the potential to perform liquidity management well with some adjustments. The building blocks and tools for effective liquidity management were mostly in place, but these lacked coherence when viewed as a full process and were not always embedded in daily activities.

Our review found that many firms attach insufficient weight to liquidity risk management in governance arrangements (SYSC 4.1.1R (1) and COLL 6.11.4R: *Duties of the permanent risk management function*) with insufficient challenge and escalation, particularly in stressed environments.

We observed a wide range of approaches to liquidity stress testing practices, with some methodologies insufficient to assess the actual liquidity of the portfolio (COLL 6.12.9R: *Measurement and management of risk*). The methodologies we found to be flawed contemplated using solely cash and the most liquid assets first to accommodate all redemptions, without any consideration of the liquidity of selling a 'vertical slice'. While the methodologies may not always reflect what happens in practice, they give a misleading view to management of a fund's true liquidity position. Some firms' oversight of stress testing was also deficient with little tracking of both actions and trends over time. Many firms had weaknesses that would not exist had they fully implemented ESMA's Guidelines on liquidity stress testing in UCITS and AIFs.

Firms typically had governance and organisational arrangements in place to meet large one-off redemptions that were uncorrelated to the wider market. But firms did not have sufficient arrangements in place to oversee cumulative or market wide redemptions that could have a significant impact on a fund. These could be substantially more difficult to execute fairly (Principle 3, COLL 6.12.11R, and SYSC 9.1.1R: *Record-keeping - General requirements*).

We found wide variation in the application of anti-dilution tools. These tools enable firms to consider liquidity costs when setting subscription and redemption prices in order that customers are treated fairly and avoid giving any investors a first mover advantage when placing orders. These weaknesses echo findings of the Joint Bank of England and FCA review, demonstrating the need for further focus on and improvement of swing pricing practices.

We found that firms' valuation processes (COLL 6.3.3R (1) and COLL 6.3.3DR: *Valuation*) for mainstream open-ended funds were reasonably robust. Most firms had separate valuation committees and defined processes for valuing less-liquid positions. However, despite these processes, internal challenge to valuations was seldom evident. The funds surveyed had very limited exposure to fundamentally illiquid positions, as opposed to less liquid positions.

Our expectations of firms

Our recent Asset Management Portfolio Letter emphasised that good governance is particularly important during this period of heightened market uncertainty. We expect accountabilities to be clear, and governing bodies to be composed of members with sufficient expertise who are given timely and appropriate management information about risk, including liquidity risk within your firm (Principles 1, 2 and 3). We expect those governance arrangements (SYSC 4.1.1R (1)) to oversee liquidity risks, including having established lines of responsibility and escalation to enable the firm to respond to volatile market conditions or redemption stress.

Firms have tools available to improve the quality of their liquidity risk management. We have concerns that they may not always oversee the use of these tools correctly or have consistent processes for deciding when and how to use them. When asset managers experience redemptions, they must meet regulatory requirements (COLL 6.2.16R: *Sale and redemption)*. Asset managers should ensure exiting and remaining investors are treated fairly when considering the costs of redemption and consider the mix of assets they use to meet redemption requests.

Asset managers should work with service providers to ensure that operational systems and processes are fit for purpose (COLL 6.6.15AR), can be executed swiftly and scaled to handle additional demand when needed.

Finally, we expect firms to perform liquidity stress testing diligently, and use liquidity management tools appropriately.

New Consumer Duty

We carried out the review before the implementation of the New Consumer Duty rules requiring firms to act to deliver good outcomes for retail customers. However, many of the examples of good practice highlighted in the multi-firm review contribute to improved consumer outcomes and are consistent with that Duty.

Our future work on liquidity

Given the international work on this topic, at this stage we are not proposing changes to the requirements for asset managers. However, as international standards evolve and as indicated in DP 23/2, we may consult on adjusting liquidity management rules and guidance to be consistent with updated global standards. We will also take account of this letter in our future supervisory work.

If you have any questions, please contact us through your normal supervisory channels (further details on our contact page) or contact Christopher Davis, the Head of Department for Market Interventions – Asset Management & Funds at Christopher.Davis@fca.org.uk.

Yours faithfully

Camille Blackburn

Director – Wholesale Buy-Side