Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Discussion Paper
An approach to macroprudential policy for investment funds

Feedback from the Alternative Investment Management Association (AIMA)

July 2024

Question 1: Do you agree with the above assessment of the potential channels through which investment funds can generate systemic risk?

The Alternative Investment Management Association ("AIMA")[1] welcomes the opportunity to comment on the Central Bank of Ireland ("CBI") discussion paper entitled "An approach to macroprudential policy for investment funds" (the "DP").[2] This DP is one of a number of pieces of work on investment funds and financial stability currently being carried out by the Financial Stability Board (FSB), the International Organization of Securities Commissions ("IOSCO") and other central banks such as the Bank of England.[3] We believe it is useful to frame our response in this wider context.

Financial stability and market integrity are key components of a well-functioning financial system and AIMA wholeheartedly supports their maintenance. However, this current focus by the FSB, IOSCO and central banks, including the CBI, is based on an analysis of a narrow category of funds. It does not acknowledge the wider variety of investment fund structures, investments, redemption and dealing periods and investors within the open-ended funds universe. This risks inappropriate and counter-productive, bank-like macroprudential requirements being applied.

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[1] The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage $800 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA): the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For more information, visit www.aima.org.

[2] https://www.centralbank.ie/financial-system/financial-stability/macro-prudential-policy/nbfi/macroprudential-policy-for-investment-funds

[3] See the FSB, "Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds: Revisions to the FSB's 2017 Policy Recommendations" (5 July 2023) ("FSB July 2023 Consultation"), and the IOSCO consultation, "Anti-dilution Liquidity Management Tools: Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes" (5 July 2023). See also Bank of England System Wide Exploratory Scenario https://www.bankofengland.co.uk/news/2023/june/boe-launches-first-system-wide-exploratory-scenario-exercise.

We are also concerned that, in common with the recent FSB work already referenced, the DP makes the underlying and incorrect assumption that open-ended funds are a principal transmitter of risk. The actions of a wide range of stakeholders, and factors such as market volatility or withdrawal of liquidity provision and other services by banks and their subsidiaries, impact funds and dictate how they respond to those pressures.

AIMA would like to make some high-level comments addressing these and other issues before responding to the DP's questions in the Annex.

- **Lack of clear evidence to justify further work**

  The current focus of the long-standing and on-going workstream seeking to address FSB concerns that open-ended investment funds could pose a risk to the stability of the financial system is on liquidity along with concerns relating to leverage. These are repeated by the DP. In 2017, the FSB issued a series of recommendations on both[4] which IOSCO[5] and national regulators have and are continuing to put into operation. A recent assessment by IOSCO of how this has been implemented demonstrates wide-spread compliance by the world's major asset management centers.[6]

  We are similarly concerned that the CBI has not made a clearly evidenced case for the kind of intervention it is proposing. The DP is also addressing a very broad issue from a narrow starting point, which is Ireland's strong position as a domicile for investment funds subject to detailed product regulations: UCITS, UCITS-based exchange traded funds ("ETFs") and money market funds ("MMFs").

[4] FSB, "Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (12 Jan. 2017).
[5] IOSCO, "Recommendations for Liquidity Risk Management for Collective Investment Schemes" (Feb. 2018).
https://www.iosco.org/library/pubdocs/pdf/IOSCOPD721.pdf
[6] IOSCO, Thematic Review on Liquidity Risk Management Recommendations (Nov. 2022).

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As we have already noted, the universe of open-ended funds is large and highly diverse. UCITS and MMFs, which are subject to eligible asset and redemption rules, are just one part of this. AIMA's members offer open-ended funds which may deal (i.e., offer subscriptions and redemptions) daily, weekly, monthly, semi-annually, annually or at other intervals as set out to investors in the funds' offering and other documents. These dealing periods reflect the underlying nature of the assets in which such funds are invested and there are regulatory requirements to ensure this.[7] These assets range from transferable securities such as equity and bonds, through to level 3 assets which include infrastructure, commodities, private credit and digital assets. In the same vein, using the behaviour of Irish open-ended real estate funds is too narrow an approach.[8]

- **Outdated comparisons**

  The aftermath of the 2007/8 global financial crisis saw a major overhaul of rules relating to a wide range of financial institutions to reduce the risk of that confluence of events combining again. Banks, as well as non-bank financial institutions ("NBFIs"), including investment funds, are subject to the extensive rules that were put in place as a result. Quoting the case of Long-Term Capital Management ("LTCM") from 1998 does not take account of this.

- **Incorrect approach to open-ended funds**

  Some of the proposals in the DP appear to take full account of the underlying dynamics in open-ended funds. The idea that funds can be grouped into cohorts which collectively may pose a risk to financial stability is a case in point. This seems to assume that if funds appear to look the same, they will then behave in the same way.[9]

[7] See, e.g., AIFMD Delegated Regulation 231/2013 article 48, Liquidity management limits and stress tests and article 49, Alignment of investment strategy, liquidity profile and redemption policy.
[8] See pages 7, 12, 37, 43 and 47 to 51 of the DP.
[9] See footnote 2 on page 5 of the DP.

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Even where the underlying assets may appear to be very similar there is a range of other factors to consider. For example, derivatives are often held for hedging and reduction of risk rather than to create leverage. The structuring and counterparties involved in margining may be entirely different. Funds' investor bases may be radically different and have very different risk tolerances and investment horizons. Nor is there any consideration of other investors' behaviour, for example, pension funds or direct investors in assets, and how it will drive asset prices and wider market behaviour. Grouping funds into cohorts in this way will not take such important factors into account. We would welcome further analysis of this concept given its importance to the DP's argument.

- **Direct investment in similar assets is not addressed**

  Open-ended funds are one of a range of mechanisms for gaining exposure to financial and other assets. It would be helpful for the DP to have explored direct investment in assets and risks relating to their disposal under stressed market conditions. Unlike open-ended funds, which employ a range of liquidity risk management tools such as anti-dilution levies, gates, swing pricing and side-pockets, direct investors in assets are free to dispose of them at will. Direct owners of assets can sell them at below market price if the need arises without there being any mechanisms in place to mitigate the possible effects of such sales. This, in turn, will affect investment funds as the assets they hold may also fall in value. This is an example of how risks are transmitted to open-ended funds, not from them.

  Continual focus on open-ended funds risks undermining confidence in them and so lead to a decline in their use. This will reduce choice, deny investors the benefits of professional investment management which brings with it the benefits of diversification and lessen the ability of managers to manage liquidity appropriately. Such an outcome would be counter-productive for all fund domiciles.

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- **The use of unproven assumptions**

  In common with the FSB's recent consultation[10], the CBI is using novel assumptions and terms in the DP. These do not bear up under scrutiny and should not be an element in the policymaking process. Of particular concern is the new and undefined phrase, "excess redemptions".[11]

  It is difficult to understand how such a concept as "excess redemptions", even if it were proven to have some form of empirical grounding, could be monitored or measured in any meaningful way. Theoretical speculation should not be used in evidence-based policymaking.

  We would welcome the opportunity to engage in more depth with the CBI on the issues raised in the DP to be able to make further submissions as the policy work on this very important subject develops. We are also happy to elaborate further on any of the points raised in this letter.

Question 2: Do you agree with the assessment in this Discussion Paper that it is primarily the collective actions of investment funds that can generate systemic risks?

As we have noted above, the DP's starting point is a series of concepts which would benefit from being explained in further detail. Some of the questions the DP asks are duplicative. Where this is the case we have grouped them together with a single response, but the original numbering has been retained for ease of reference.

Response to Questions 1 and 2: The DP proceeds from the incorrect assumption that investment funds are by default the source of potential systemic risk. It bases this idea on the premise that investment funds have reached such a critical mass in assets under management that any actions they take in common pose a de facto financial stability risk.

[10] FSB July 2023 Consultation, supra note 2.
[11] See the DP, page 38.

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This ignores the behaviour of a wide range of other stakeholders in financial markets. For example, investment funds did not create the dislocation in the UK gilts market that led to problems for pension funds running LDI strategies. The dislocation was caused by the actions of the UK government. Pension funds, investment funds and other vehicles investing in UK gilts reflected the fall in asset value those actions precipitated. Similarly, as we have noted above, direct owners of assets may behave in a correlated manner which has the potential to impact investment funds. Further, banks and their prime broker subsidiaries could, for example, decide to revalue assets which investment funds use as collateral. This could force investment funds to post more collateral.

Question 3: Do you agree that the current regulatory framework for funds - which has primarily been designed at a global level from an investor protection perspective – has not been sufficient to reduce the propensity of certain fund cohorts to amplify shocks?

We agree that a key part of asset management regulation is to ensure that all investors are treated fairly. This reflects the fact that investment funds do not carry the same magnitude of risk to the financial system as financial institutions such as banks and insurance companies who must reserve money to meet guarantees to their customers. The behaviour and performance of funds reflects the underlying performance and behaviour of the markets and assets they are invested in. While the amount of assets under management in investment funds may have increased, this underlying truth has not changed.

The aftermath of the Great Financial Crisis ("GFC") saw a significant expansion in financial regulations. Non-bank financial institutions such as investment funds are now subject to very robust and comprehensive sets of rules. Many of these rules explicitly relate to financial stability.

This is sometimes embedded in their mandates and/or reflected in their rules. Rules do not need to be labelled "for financial stability purposes" to be relevant to it. This is the case for the structure of funds which, for example, require on-going and fair valuation and

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that redemption terms are suitable to the assets they invest in. The DP fails to recognise or acknowledge this, other than in relation to the AIFMD's leverage rules, for example, with the wider market stability and integrity requirements in the AIFMD's delegated regulations.[12]

For example, the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act put in place a series of extra requirements after the GFC which the U.S. Securities and Exchange Commission ("SEC") continues to point out are specifically designed to promote financial stability.[13] Similarly, in the UK, the Financial Conduct Authority's statutory objective of ensuring market integrity contain financial stability considerations.[14] Investment funds are subject to extremely robust regulation and have access to a very wide range of liquidity risk management tools. Many jurisdictions have given access to such tools to asset managers for many years. The request to systematise this availability by the FSB in 2017 and give it effect it by IOSCO in 2018,[15] continues to be put into national rules by securities regulators. IOSCO has also assessed the progress of this work and found that the world's major asset management and fund hubs have carried this out effectively.

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[12] Commission Delegated Regulation 231/2013, article 17, "Duty to act in the best interests of the AIF or the investors in the AIF and the integrity of the market, 1. AIFMs shall apply policies and procedures for preventing malpractices, including those that might reasonably be expected to affect adversely the stability and integrity of the market." https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:en:PDF.

[13] See Statement of SEC Commissioner Jaime Lizárraga, "Enhancing Financial Stability and Fulfilling Our Investor Protection Mandate" (3 May 2023).

[14] The UK Prudential regulatory Authority's financial stability information power can be summarised as "a power to require a person to provide information or documents relevant to the stability of one or more aspects of the UK financial system." See https://www.handbook.fca.org.uk/handbook/glossary/G2778.html. FSMA 2000 section 1A and 1EA extend this requirement to core activities not regulated by the PRA: https://www.legislation.gov.uk/ukpga/2000/8/chapter/1/crossheading/modifications-applying-if-core-activity-not-regulated-by-pra.

[15] See footnotes 2 and 3.

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As we have already noted in the covering letter, the idea that funds can be simply grouped into "cohorts" does not recognise the diversity of strategies, the underlying instruments used and investors' varying risk appetites and investment horizons. In the absence of the kind of robust analysis that should underpin this argument, the concept of "cohorts" has no more meaning than the marketing device of grouping funds into "growth", "equity", "bonds" or other categories.

Question 4: Do you agree with the key proposed objectives and principles of macroprudential policy for funds as set out in this Discussion Paper? Are there additional principles, which need to be considered?

AIMA is pleased to see that the CBI accepts that asset managers must retain responsibility for risk management, it is not the intention of the DP to try to regulate asset prices and there is recognition that any regulation needs to be flexible and be able to accommodate different types of investment funds. But as we argue above, the CBI wants its proposed framework to rest on the flawed concept of cohorts of funds that will always behave in the same or similar way during stressed periods.

Investment funds are already subject to ex-ante regulations. They must take account of the nature and the time it may take to buy and sell the assets they are intended to invest in, the target audience of investors and the redemption period offered. Asset managers are also required to stress test investment funds both before they are offered to investors and over their lifecycle.[16]

[16] AIFMD article 16 Liquidity Management; UCITS Directive article 50, Eligible Assets; also CESR Risk management principles for UCITS, Part 3, Identification and measurement of risks relevant to the UCITS, Part 4, Management of risks relevant to the UCITS and Part 5, Monitoring and reporting: and the IOSCO Thematic Review on Liquidity Risk Management Recommendations which sets out individual authorities' implementation of IOSCO's 2018 Recommendations which cover these issues See recommendations and jurisdictions' compliance with Recommendations 1 to 4 and 7, CIS design phase, Recommendations 10, 12 and 14, day to day operations and Recommendations 16 and 17 contingency planning. https://www.iosco.org/library/pubdocs/pdf/IOSCOPD721.pdf.

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The DP singles out liquidity mismatches and leverage as particular issues it believes should be addressed. The FSB and IOSCO work, cited at length, already addresses the issues of assets being available in time to meet redemption requests. The very recent revision of the AIFMD and UCITS Directives also implements FSB's recommendations, for example, in requiring funds to have a minimum number of liquidity management tools at their disposal. There are already significant and robust requirements such as appropriate risk management, collateral and margining as well as the disclosure of main counterparties on leverage.

The DP is not clear as to who would be expected to make ex-ante decisions applying to entire groups of funds or markets. It also contradicts the outcome of the revisions to the AIFMD which continues to locate these key decisions with the manager. A central bank or securities regulator charged with making such a decision will be carrying a very significant degree of regulatory jeopardy; that is to say, the risk of intervening unnecessarily may turn a problem into a crisis. The DP notes that ex-ante decisions will need to be made on a global basis for them to be effective. This would be an extraordinarily complex and politically fraught issue to address, but the DP does not explore this key challenge in any meaningful way.

Question 5: Do you agree with the analysis and the issues highlighted pertaining to the design of potential specific macroprudential tools for the funds sector? Are there are additional potential tools that could be explored?

AIMA has consistently advocated that the widest range of appropriate risk management tools should be available to funds. Creating such availability globally is one of the key aims of the FSB and IOSCO work in 2017 and 2018 discussed above. Many jurisdictions already allow funds to use a wide range of risk management tools, often to manage liquidity and there is on-going work to increase their availability.[17] A major reason for successful

[17] For example, see the updated AIFMD2 and SEC Prosing Release, "Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting", 87 FR 77172 (16 Dec. 2022) on liquidity risk management.

application of these tools is that they are applied at the individual fund manager's discretion, taking account of the underlying assets, liabilities, investment techniques, strategies and investor bases of the funds they run. Any attempt to apply them is a blanket manner to "cohorts" of funds will likely be unsuccessful and probably counter-productive.

- **Liquidity management tools ("LMTs")**
  It is important that the functions of this wide range of existing tools are properly understood and are not misapplied. The DP's idea of "a more prescriptive regulatory framework governing the use of price-based LMTs, covering swing factors and thresholds" is a case in point.

  Swing pricing is a method that ensures fairness in the allocation of costs between subscribing, redeeming and remaining investors in a fund. When it is successful, that success is because it is applied on a fund-by-fund basis recognising the individual circumstances and composition of each fund. Any attempt to impose a market wide application will effectively turn it from a tool to manage fairness into a penalty for investing in or withdrawing from a fund. The mechanistic approach implied by the idea of increased prescription will also allow more sophisticated investors to forecast when such tools will be applied and redeem beforehand, ironically increasing the risks the CBI seeks to reduce.

  In relation to the DP's suggestion that there should be wider use of notice periods, AIMA notes that there is no requirement in EU fund legislation for daily dealing, for example, UCITS must offer subscriptions and redemptions on at least a bimonthly basis. AIMA has consistently argued that a difference should be drawn between retail and professional/institutional open-ended funds. The former are often mandated to deal on a daily or very frequent basis and can only invest a range of assets whose eligibility is often based on their immediate liquidity. The latter invest in a wide range of assets, some of which may be liquid and others illiquid. The dealing frequency of professional/institutional

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open-ended funds could be daily, monthly, quarterly, semi-annually, annually or anything in between depending on the liquidity characteristics of those assets. Professional investors carry out detailed due diligence of funds to understand whether they meet their performance, risk and liquidity requirements. This often goes beyond regulatory requirements. The DP's suggestion that there be more prescriptive regulatory requirements is therefore unnecessary.

- **Leverage**

Funds that make use of leverage are subject to a wide range of detailed rules on both managing any extra risks that it may create via the use of collateral, margining and other mitigants as well as extensive reporting requirements. The recent reviews of both the AIFMD and the UCITS Directive did not identify any gaps or major issues in relation to leverage so it is surprising that the CBI is raising some now.

The DP raises the issue of measuring leverage but does not refer to the reporting requirements in Annex IV of AIFMD or the extensive work carried out by IOSCO to increase the amount of data on leverage globally.[18] Nor does it explore other sources of data on leverage from, for example, banks and their prime broker subsidiaries. Funds in many jurisdictions are already required to disclose their largest sources of borrowed cash or securities for each fund.[19] Key counterparties are therefore already disclosed and regulators can see to what degree they are exposing themselves to any concentration of risk. In addition, those counterparties should make data available on how they are managing their exposures incurred in facilitating leverage in funds

[18] See IOSCO, "IOSCO report provides new insights into global investment funds industry" (27 Jan. 2023).
[19] AIFMD delegated regulation 231/2013, pages 94 and 95.

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The DP also introduces the new concept of "leakage" as a risk in its proposed framework. This is another new concept which requires further definition to understand whether it is relevant to this debate.

Question 6: Do you agree that tools could target the interconnectedness of funds as well as/instead of their vulnerabilities?

This question is based on the idea that investment funds are the main transmitters of risk in the financial system, which is not the case. As we have already noted, other market participants and other stakeholders can create financial instability. This does not take full account of the complexity and nature of financial markets where risk is transmitted between all players, all of whom should already have mitigants in place to manage it. This applies equally to banks and their subsidiaries, pension funds and insurance companies as it does to investment funds.

However, AIMA welcomes the DP's concern that amending existing requirements such as for margining would be very complex and could lead to unintended consequences such as pressure on liquidity.[20]

Question 7: Do you agree with the governance and data considerations highlighted in this Discussion Paper when operationalising macroprudential policy for funds?

AIMA supports consistency of definitions and requirements across jurisdictions. As we have already discussed, the DP does not acknowledge the significant amount of work carried out by IOSCO in relation to this. Similarly, it does not acknowledge the role already played by global standard setting bodies such as the FSB and IOSCO in facilitating greater coordination of rules and data.

[20] See the DP page 45 "One of the potential drawbacks of the use of margins in this way, beyond the operational complexity, is whether they reduce counterparty credit risk at the cost of increasing liquidity risk."

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Further calls for funds to provide even greater levels of data should not be made until it is clear such data is not already available elsewhere, for example from counterparties such as banks and prime brokers. The accumulation of data should not be an end in itself. There needs to be clear justification for further data reporting. The European Commission's Burden Reduction Package is a welcome recognition that the continual request for data can be counterproductive and unnecessarily burdensome.

Question 8: Beyond governance and data considerations, are there additional issues that need to be considered when operationalising macroprudential policy for funds?

Please see our response to question 7.

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