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Irish Funds Response to Central Bank of Ireland Discussion Paper 11 - An approach to macroprudential policy for investment funds

November 2023

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Irish Fund's Draft Response to: Central Bank of Ireland Discussion Paper 11

Executive Summary

The Irish Funds Industry Association (Irish Funds) is the representative body for the international investment funds industry in Ireland. Our members include fund managers, fund administrators, transfer agents, depositaries, professional advisory firms, and other specialist firms involved in the international fund services industry in Ireland. By enabling global investment managers to deploy capital around the world for the benefit of internationally based investors, we support saving and investing across economies. Ireland is a leading location in Europe and globally for the domiciling and administration of investment funds. The funds industry employs over 17,000 professionals across every county in Ireland, with over 34,000 of a total employment impact right across the country and provide services to 8,766 Irish regulated investment funds with assets of EUR 3.855 trillion (CBI statistics 29/09/2023).

Irish Funds welcomes the publication of Discussion Paper 11 "An approach to macroprudential policy for investment funds" (the "Paper") and the opportunity the Paper provides to engage in a meaningful dialogue with the Central Bank on such an important and challenging topic. We also invite the Central Bank to consider Irish Funds' responses to the Financial Stability Board's (FSB) consultation "Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds" and the International Organization of Securities Commission's (IOSCO) consultation "Anti-dilution Liquidity Management Tools – Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes". We concur with the Central Bank's recognition of the diverse nature of the funds sector and the Paper's emphasis on the inappropriateness of applying one-size-fits-all banking-style regulations to the funds sector. However, we also believe that the EU already has in place, and is in the process of enhancing, a robust regulatory and supervisory framework under the EU AIFMD and EU UCITSD, supplemented where relevant by further regulation such as the EU MMFR.

The Paper notes that the primary objective of macroprudential policy is "*to ensure… the financial sector is more resilient to stresses and less likely to amplify adverse shocks*" and clearly identifies that it should not aim to "*target asset prices.*" While targeted interventions to safeguard against undue market pressure may be justified in specific scenarios, the prevention of 'amplification' should not be misconstrued as hindering price changes resulting from funds' trading activities. We also welcome the acknowledgement that "*it is also not the aim of macroprudential policy to replace or substitute for funds' or investors' own risk management practices*[1]*.*" We concur that the ultimate responsibility for the liquidity risk management of individual investment funds resides and should remain with the relevant fund manager, a principle recognised also by the FSB and IOSCO, as well as other regulators globally.

The Paper acknowledges that "*the assessment of systemic risk posed by the funds sector is still evolving" and "needs to take into account developments in the broader ecosystem of markets including the broader composition of market participants and drivers of liquidity demand and supply*[2]*.*" As such, in seeking to better understand the concept of

[1] Page 32 – Discussion Paper 11
[2] Page 4 – Discussion Paper 11

interconnectedness, and the potential risks attached, policymakers should first seek to undertake system-wide analysis and, thereafter, stress testing, based on the information already reported by asset managers and other relevant financial market participants. The Bank of England, for example, has launched a system-wide exploratory scenario[3] with the intention of improving its "*understanding of the behaviours of banks and non-bank financial institutions (NBFIs) during stressed financial market conditions.*"

Question 1:

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

Answer 1:

As outlined in our executive summary, we agree with the Central Bank's view that investment funds are different to banks, and we would see development of macroprudential policy in the funds sector as intending to complement existing robust regulatory frameworks governing the sector. We also agree with the Central Bank that the funds sector is playing an increasingly important role in the wider global financial system and that the increased financial intermediation via the funds sector brings many benefits to the real economy. As presented in Chart 3 of the Paper "*approximately half of Irish funds' assets are invested directly into the global real economy*".

However, as noted in the Paper, investment funds are "*part of a broader ecosystem of market participants in capital markets*" and "*In assessing the systemic footprint of the funds sector, therefore, it is important to consider the broader ecosystem of participants in capital markets and the interaction of investment funds with these types of financial institutions*[4]". In addition, it is recognised that the assessment of systemic risk posed by the funds sector is still evolving. Therefore, in order to avoid any unintended consequences, it is of critical importance to ensure that the potential issues and challenges with a future macroprudential policy framework are well thought out, evidence based, and appropriately and rigorously stressed tested. This is vital to ensure that any Macroprudential policy changes achieve the purpose and objective for which they have been designed and do not inadvertently damage the real economy or increase vulnerabilities in the financial sector which would be counter to their intended purpose.

There are differing views between some stakeholders as to the systemic importance of the fund sector. The Paper acknowledges that the Irish funds' sector's linkages to the domestic real economy are relatively small when compared to the size of the sector (albeit increasing), noting that the Central Bank has taken action where there has been domestic concentration e.g., Property funds and LDI funds. We can agree that the sector has grown significantly in the period since the global financial crisis and that any matter which impacts a cohort of the funds sector, could have implications for the financial system and real economy due to the interconnectedness which the funds sector has with the banking sector, the other sections of the non-bank sector and the real economy. History has shown that the kinds of events which trigger movement across a specific cohort of funds, are events which also have an impact across the global financial sector and the real economy. However, it is important to note that

[3] The Bank of England's system-wide exploratory scenario exercise | Bank of England
[4] Page 13 – Discussion Paper 11

events like the great financial crisis, the COVID-19 pandemic and LDI were all different and had different impacts on the funds sector, the wider financial system and society.

Due to the size of the funds sector, the relationship of different cohorts of funds with the wider financial system and its global and portable nature, we strongly agree with the Central Bank's view that international coordination, across the entire financial system, is needed to consider, evaluate, develop and operationalise a macroprudential framework for the funds sector which is fit for purpose and which addresses the specific characteristics and unique features of the funds sector. In this regard there must be consideration given to the downstream impact of any macroprudential policy activated for the funds sector, as to date the interconnectedness impacts tend to be event specific.

We also strongly agree with the Central Bank's view that actions will only be effective if there is effective regulatory coordination and therefore would not be in favour of regulators acting unilaterally or within a narrow group. We firmly believe that there is a material risk that the failure to engage in such international coordination across the entire financial system could result in the transfer or transformation of macroprudential risks within the financial system, rather than the intended mitigation or reduction in such risks. Additionally, we are concerned that the implementation of a regulation intended to address a risk in one section of the financial system could result in the transfer or transformation of that risk to another part of the financial system, due to the substitutability of one product, service or location for another (e.g. the move of leverage to unregulated parts of structures to avoid restrictive leverage limits in regulated funds). The net result is that the overall level of risk is not reduced.

We should also not overlook the fact that there is already a significant body of regulation impacting the funds sector directly in the areas of liquidity risk management, leverage and valuation which can address potential channels of transmission of risk which therefore already plays a role in managing and mitigating macroprudential risk.

We do agree with the Central Bank when it says that the funds sector is diverse, with different types of fund cohorts presenting different systemic risk profiles. As a result, we think that a "one-size" fits all approach would not be the correct approach to addressing macroprudential policy considerations and that a tailored principles-based and flexible approach which recognises the different levels of potential risk, and the specific features and unique requirements of the different fund cohorts would be more appropriate. Overall, it is important to note that many fund types may span different "cohort" brackets e.g., multi-asset, and may evolve over time. Additionally, grouping by cohort appears not to consider the different investor bases of funds. These investor bases would drive the liquidity demand of the fund.

In our view the Paper does not adequately consider the "Agency model" which underpins how the funds sector operates. The interplay between any potential macroprudential policy framework and the fiduciary duty which underpins this Agency model needs to be fully examined in this discussion. The Agency model in the context of the funds sector typically refers to the relationship between the investment fund, its management company, and the investors. In this model, the fund manager acts as an agent, making investment decisions on behalf of the investors (the principals) who have entrusted their money to the fund for a specific purpose e.g., saving for retirement, saving for their children's education, investing premiums to fund future insurance claims or saving excess cash for a rainy day. The Agency model is fundamental to the functioning of investment funds, as it establishes a framework of trust and accountability between the fund manager and investors. The agency relationship carries a fiduciary duty, meaning that the fund manager has a legal and ethical obligation to act in the

best interests of the investors[5]. This duty includes making prudent investment decisions, managing risks, and disclosing relevant information to the investors. We note the Central Bank highlight the potential of "Incentive Frictions," which references competitiveness and reputational concerns when it comes to fully deploying LMTs. From an Irish perspective it is our understanding that the use of anti-dilution LMTs, in particular, are commonly used, and additionally post-Covid most firms will have liquidity playbooks in place which helps guide the liquidity management process, including during periods of stress. However, access to liquidity is not uniform and it is the responsibility of the Board to deploy LMTs in response to specific events, redemption scenarios, flows etc. Their deployment may not always align as the characteristics of funds can vary but as long as there is a broad set of LMTs available this supports overall financial stability through robust risk and liquidity management procedures.

Allied to the Agency model is the issue of interconnectedness. In our view the Paper fails to fully consider and address all aspects of the interconnectedness of the funds sector because the analysis included in the Paper only considered interconnectedness through the vectors of direct counterparty relationships and indirect asset sales and collateral value channels. Another vector of the interconnected nature of the funds sector is the ownership which other sections of the banking and non-banking financial system have in the funds sector. Looking at the European funds industry at the end of Quarter 2, 2023 in the most recently published quarterly statistical release from EFAMA, Insurers & Pension Funds (41%) and Other Financial Intermediaries (26%) owned 67% of investment funds in Europe[6]. In his recent speech, Andrew Hauser from the Bank of England noted that insurance companies and pension funds were the biggest NBFI sellers of UK Gilts in both the "dash for cash" and the LDI episodes[7]. Significantly, Mr. Hauser highlighted that as a result of these events, the Bank of England with immediate effect will embark on "*the design of a facility allowing us to lend to insurance company and pension funds (ICPFs)*."

Therefore, a complete analysis of the channels through which the funds sector may transmit or amplify potential macroprudential risk needs to also consider the mechanisms through which the funds sector is impacted by upstream activities in insurers, pension funds and other financial intermediaries, and the impact which any macroprudential policy framework could have on these upstream stakeholders as well as considering the downstream impacts as set out in the Paper. In other words, if different areas of the financial system (e.g., insurance and pension funds) need to generate liquidity from their investments in the funds sector, what is the impact on the wider financial system? And could macroprudential policy in the funds sector end up directly impacting the liquidity needs of these large cohorts of the financial system and actually increase stress across the wider market?

The law of diminishing returns suggests that the benefit that any additional regulatory change may generate to mitigate or reduce potential systemic risk in the funds sector needs to be carefully weighed against damage to the real economy resulting from the direct and indirect costs from the reduced investment returns such as reduced pension payments to pensioners and lower capital available for future investment.

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[5] Section 53E (1) of the 2010 Act as amended Central Bank (Individual Accountability Framework) Act 2023 (irishstatutebook.ie)

[6] European 2023 Q2 Quarterly Statistical Release.pdf (efama.org)

[7] "A journey of 1000 miles begins with a single step: filling gaps in the central bank liquidity toolkit" – speech by Andrew Hauser given at a Market News International Connect Event, Chartered Accountants' Hall, London

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?

Answer 2:

In the first instance we concur with the Central Bank's view that the crystallisation of the potential underlying vulnerabilities in the funds sector and the transmission of a shock does require a market trigger event or shock. Examples provided in the Paper include the GFC and the COVID-19 pandemic. These events had global and cross-sectoral impacts and implications far beyond the funds sector. However, in considering if it is primarily the collective actions of investment funds that can generate or amplify systemic risk we feel it is important to recognise that there is a difference between exogenous risks such as Covid which may trigger and expose existing vulnerabilities in the financial system, and endogenous risk which can be idiosyncratic events such as was the case with Long-Term Capital Management (LTCM). Therefore, it is important to recognise that it is not factually correct to conclude in all cases that the collective actions of funds generate systemic risk, and a case-by-case analysis is required before coming to a conclusion.

Going back to the agency model point which we referenced in our response to Question 1, the Paper does not address the potential impact which such trigger events or shocks had/have on the investor base of funds (particularly, the 67% of funds owned by insurers, pension funds and other financial institutions as referred to in Question 1.[8]) and whether in fact it is the concerted actions of large elements of this investor base which is the driver for the collective actions taken by investment funds.

These, "institutional" investors also benefit from better financial literacy than the typical retail investor and also have better access to the kinds of financial information which may prompt their actions in times of potential stress. One also has to consider that such actions may be prompted by fiduciary, contractual, or regulatory obligations which institutional investors such as pension funds and insurance companies are required to adhere to.

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?

Answer 3:

Whilst we believe that elements of the current regulatory framework might be refined so as to better absorb market shocks, we would not necessarily agree that the current regulatory regime has proved insufficient in reducing the propensity of certain fund cohorts to amplify shocks. Although certain fund cohorts may contribute to pockets of risk, the current blend of micro and macro supervision has proved largely effective in preventing the build-up of systemic risk across the sector. The Paper notes that market disruption shows the potential for the funds sector to amplify shocks. However, the November 2020 ESMA report on Recommendation of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds noted that those funds with large corporate debt exposure generally managed to

[8] European 2023 Q2 Quarterly Statistical Release.pdf (efama.org)

maintain stable portfolios during the COVID-19 crisis and, in stress testing them, found that "*more than 86% of AIFs and 90% of UCITS*[9] *"* (would be) resilient to the shocks tested.

The degree of flexibility afforded by the use of the available liquidity management toolkits to date has avoided their mechanistic implementation by managers and so mitigated risk of the so called 'cliff edge effect' which may have only served to amplify shocks. We welcome the forthcoming refinements to the existing regulatory framework for funds, particularly regarding the availability and use of LMTs, which will complement the existing investor-focused protections.

The Paper acknowledges that it important, when considering the systemic role of funds, to consider the broader ecosystem of participants in capital markets and the interaction of funds with them, this is particularly the case for MMFs. Regulatory reforms and regulatory commentary about potential reforms have often acknowledged this but have typically focused on microprudential measures regarding the behaviour of individual funds. A macroprudential focus is welcome but it has to look beyond the particular cohort of funds and focus on the broader ecosystem. MMFs are one stakeholder in the short-term financing space and, just as it would be wrong to focus solely on individual MMFs as opposed to the whole cohort, it would also be wrong to focus on one stakeholder and expect it to solve for the whole ecosystem.

Through the blend of micro and macro supervision adopted in Ireland, together with the significant data collated by supervisory authorities from a wide range of market participants, we believe that the regulatory framework will be in a position to continue to anticipate, recognise and react to system-wide dynamics and therefore given the existing EU regulatory framework, we question the need for any significant changes through additional macro prudential policy measures.

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?

Answer 4:

We broadly agree with the proposed objectives and principles of macroprudential policy as set out in the Paper, though believe great care should be taken in considering specific policies at a cohort level. The range of initiatives proposed acknowledges that a holistic, system-wide approach should be adopted in looking to guide macroprudential policy and we agree that it is important not to rely solely upon individual managers to avoid systemic risk build-up. We particularly welcome the acknowledgement that international co-ordination will be critical to the successful adoption of any macroprudential framework and believe this to be a fundamental point which must underpin any future policy developments. Equally, we welcome the recognition that any macroprudential framework for funds cannot simply be an "*extension or replication of the macroprudential framework applied to the banking sector*[10]." We

[9] Pg 40 section 5.4 paragraph 76. esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf (europa.eu)
[10] Page 32 – Discussion Paper 11

acknowledge that the data available to the Central Bank and other NCAs continues to improve and therefore risk assessments are likely to deepen and more accurately identify risks depending on specific cohorts. However, we believe further data improvements are needed to avoid unintended consequences and therefore we would welcome further engagement with the bank on this point. Overall, as per our response to Question 1, it is important to note that many fund types may span different “cohort" brackets e.g., multi-asset, and may evolve over time. Additionally, grouping by cohort appears not to consider the different investor bases of funds. These investor bases would drive the liquidity demand of the fund.

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?

Answer 5:

As referenced in question 4, we broadly agree with the principles articulated throughout the Paper for underpinning the design of a successful macroprudential framework. We would also support the Central Bank’s acknowledgement that, “*investment funds… are different to banks, so a macroprudential approach to the funds sector cannot simply be an extension or replication of the macroprudential framework applied to banks*[11].” We also agree that the “*approach to systemic risk assessment needs to account for the heterogeneity in investment funds’ business models and, therefore, differences in the way in which different fund cohorts can generate systemic risk. It also needs to take into account developments in the broader ecosystem of markets, including the broader composition of market participants and drivers of liquidity demand and supply*[12].”

Understanding these fundamental principles of heterogeneity is an important first step towards ensuring that any potential macroprudential framework for the heavily regulated funds sector would be proportionate, appropriately calibrated, and mindful of the wider financial market ecosystem in which investment funds operate.

Furthermore, we concur with the Central Bank acknowledgment of other key principles. One of these principles underscores the acknowledgement that the funds sector’s diversity renders a “one-size-fits-all” approach to investment funds’ liquidity risk management impractical. Another vital principle highlighted is that ultimate responsibility for the liquidity risk management of individual investment funds resides and should remain with the relevant fund manager, a principle recognised also by the FSB and IOSCO, as well as other regulators globally.

It is in the context of these key principles that we consider the Central Bank’s analysis of the issues highlighted in relation to the potential utility of a macroprudential framework for the funds sector.

In terms of liquidity management, we note that the Central Bank, like the FSB and IOSCO, references a relationship between potential liquidity mismatches and “‘excess’ asset sales” during periods of underlying market stress, but does not seek to define or evidence the existence of excess asset sales, nor what might be considered an appropriate level of asset

[11] Page 3 – Discussion Paper 11
[12] Page 4 – Discussion Paper 11

sales. Notwithstanding the limitations of this analysis, we agree with the underlying principles that it is incumbent upon asset managers to seek to mitigate and manage potential liquidity mismatches in investment funds.

In this regard, Irish Funds asserts that, in pursuit of macroprudential tools and practices, the most impactful approach revolves around prioritising the availability and use of a broad suite of liquidity management tools. Any use of such tools should be defined and informed by the individual circumstance of each fund rather than a general or high-level market definition of "normal" or "stressed."

We note that the primary purpose of liquidity management tools is to ensure investor protection by managing liquidity and, where applicable, mitigating material dilution to existing/remaining investors by appropriately attributing, where necessary, estimated liquidity costs to subscribing/redeeming investors. In addition, we note the Central Bank's assertion that appropriate use of price-based liquidity management tools can contribute towards the mitigation of potential first-mover advantage related to the inappropriate attribution of estimated liquidity costs.

Notwithstanding the above, we also note IOSCO's statement that it can be "*difficult to quantify and determine the materiality*[13]" of potential first-mover advantage in this regard. IOSCO also states that "*there is some evidence that a first mover advantage may also exist at market-wide level stemming from wider market dynamics and may not be unique to OEFs*[14]" and therefore it is not a phenomenon specific to investment funds. In any case, we agree that the use of price-based liquidity management tools have the potential to mitigate against first-mover advantage and ensure that remaining investors do not bear the costs of any capital activity. If this outcome is achieved across the funds sector, then this can contribute towards the broader stability of the financial system.

We believe that the EU already has in place, and is in the process of enhancing, a robust regulatory and supervisory framework governing the availability and use of such liquidity management tools under the EU AIFMD and EU UCITSD, supplemented where relevant by pursuant legislation or, indeed, further regulation such as the EU MMFR.

Of course, it is important to note that the use of certain liquidity management tools implies specific consequences. For example, the application of a swing pricing mechanism may be dependent on the ability of fund service providers to facilitate it (i.e., not all fund service providers can facilitate a 'tiered' approach to swing pricing as discussed by IOSCO). Moreover, not all retail intermediaries are, as yet, capable of or willing to distribute non-daily funds or funds which use e.g., notice periods[15]. The infrastructure for retail-focused investor platforms

[13] Page 6 – IOSCO Consultation

[9] Footnote 7 Page 6 – IOSCO Consultation

[15] Extended notice periods may be appropriate for funds investing in inherently illiquid assets with regular liquidity windows, such as real estate or specialised alternative strategies. Extended notice periods should not be required for open-ended funds invested in public securities that trade on an intraday basis. This would disadvantage their fund investors vis-à-vis investors holding assets on their own account or through other investment vehicles. Institutional investors would likely migrate assets out of funds and into other structures, disadvantaging retail investors without that option. Also, as per our response to the recent FSB consultation, there

across Europe is calibrated towards daily dealing funds. Where funds were to move to a different dealing frequency the operational infrastructure would struggle to support this and as such deprive investors of choice. Undertaking a further assessment of and taking remedial action in response to such phenomena in relation to liquidity management tools would be a welcome next step by policymakers.

In terms of the relevance of liquid asset buffers for funds other than MMFs, we agree with the Central Bank that such measures would act procyclically during periods of underlying market stress, in particular given the fact that, as IOSCO acknowledges that it is not always possible for asset managers to buy or sell assets using vertical slicing[16]. Broader use of liquid asset buffers would also give rise to asset herding, impact fund performance, and potentially run counter to the investment strategies and objectives of the types of funds for which the Central Bank may consider them useful. It is our strong view that broader use of liquid asset buffers should be avoided in the funds sector.

Finally, the Paper highlights the work being done and proposals being put forward internationally in relation to the international proposals put forward in relation to enhancing the resilience of open-ended funds and MMFs. While we support some of those recommendations (e.g., enhancing the availability and use of liquidity management tools for open-ended funds, removing the link between liquid asset buffers and the potential application of fees and/or gates for MMFs, etc.), there are specific proposals with which we strongly disagree, in particular the FSB's proposed liquidity bucketing for open-ended funds, as well as the various 'bank-like' reforms recommended for MMFs (e.g., capital buffers).

In terms of leverage, there is a need to better differentiate between leverage used for risk reduction and leverage used for return amplification purposes. We would also ask for regulators to better consider the reporting on leverage which is already delivered to them by the funds sector. In particular by those funds deemed to be using leverage on a substantial basis (>300%). There already exist various disclosure requirements such as AIFMD Annex IV, Fund Profile Returns and Annual FDI Returns for funds in this regard, and regulators already have intervention powers to impose limits on the use of leverage by certain funds, of which the Central Bank has already availed of itself[17]. As such, we encourage the Central Bank, and regulators more broadly, to further assess the fund sector's use of leverage, and consider it more appropriately as an ongoing supervisory issue, rather than an area which merits further regulation.

Relatedly, it is essential that regulators ensure that these additional reporting requirements do not burden market participants with excessive compliance costs. For example, European investment funds already provide extensive data/information to their national competent authorities and central banks. It is important that the latter authorities cooperate closely, to ensure investment funds report the relevant supervisory information only once.

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can be cases where an extended settlement period is more appropriate than a notice period, and as such discretion should be retained by the manager as to what is the most appropriate tool for each fund.

[16] Footnote 25 Page 15 – IOSCO Consultation

[17] In November 2022, the Central Bank announced the phased implementation of a leverage limit of 60 per cent on a total-debt-to-total-assets basis using Article 25 of AIFMD to address the excessive build-up of leverage in Irish-domiciled property funds.

More broadly, there are a number of issues relating to the broader financial market ecosystem which the Central Bank has not considered in the context of a potential macroprudential framework for investment funds but which we believe are important in enhancing the resilience and effective functioning of financial markets more broadly as follows. These were also highlighted in the recent EFAMA paper[18]:

- Following the review of the EU MiFIR framework, establishing an effective consolidated tape for equity, equity like and fixed-income securities, would provide greater transparency in times of market volatility. An effective consolidated tape would support market participants in identifying the most liquid markets, support best execution reporting, and allow supervisors to monitor market developments more closely during periods of market stress.
- Facilitating the use by banks of their liquidity buffers during periods of stress would allow broker-dealers to expand their balance sheets further during such periods of uncertainty. During March 2020, broker-dealers were unwilling to dip into their buffers to provide additional liquidity to the market, despite the fact that they were designed for this exact countercyclical reason. Greater guidance from bank regulators on when and how broker-dealers can use these liquidity buffers would significantly contribute to the resilience of capital markets.
- Improving CCP margin transparency and predictability, to avoid spikes in margin calls during periods of market stress as experienced during the COVID-19 crisis. This would avoid the excessive flow of liquidity away from markets. CCPs could use appropriate model assumptions to size initial margin requirements proportionately (for example, historical market trends and margin period of risk) to mitigate the potential for future procyclical initial margin moves.
- It is equally important to ensure that brokers' collateral policies – including for investment funds – are sufficiently transparent to those investors that use their services, as we understand that brokers may impose additional margin requirements on their clients on top of those required by CCPs. Lastly, to alleviate unintended liquidity pressures from margin calls, we recommend expanding acceptable collaterals to include, for example, PDCNAV MMFs and certain qualifying ETFs.
- Consolidating supervisory reporting across all financial sectors, to allow macro-prudential supervisors to form a more complete overview of the European financial system. Indeed, to conduct a comprehensive systemic risk analysis, it is not sufficient to only leverage supervisory information on the behaviour of investment funds, particularly given their relatively limited footprint in capital markets.

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

Answer 6:

In Europe, the funds sector is substantively regulated, with existing legal frameworks already under significant reform following, for example, the recent EU AIFMD/UCITSD Review, including a new pan-EU framework governing loan-originating funds. This will be further supplemented via regulatory technical standards (RTS) and guidance. Additionally, the

[18] Open-ended funds and resilient capital markets.pdf (efama.org)

regulatory and supervisory framework governing ELTIFs has recently been updated, with forthcoming RTS to underpin it and the upcoming reform to MMF liquidity risk management will be implemented via the EU AIFMD/UCITSD review. This broad regulatory and supervisory framework is supplemented by a stringent stress-testing regime, which contributes in turn to the overall calibration of managers' liquidity risk management frameworks.

We would suggest that proportionate supervisory engagement on potential issues related to interconnectedness may be as effective and less burdensome than other proposals to further encourage fund managers to ensure greater availability and use (and greater consistency in the use) of the LMTs at their disposal in the appropriate circumstances. In this regard, we reiterate our support for the Central Bank's acknowledgement that ultimate responsibility for the management of individual investment funds sits and should remain with the relevant fund manager, a principle recognised by the FSB and IOSCO, and that a one-size fits all approach is not intended or practical.

In addition, we would stress that it is important to ensure that the distinction, in fact and in form, between fund managers (and the asset management sector as a whole), and the banking sector is made clear. Stress testing methodologies developed in the banking sector focused on solvency not liquidity, further fund managers are dealing as agent not as principle and investments by investment funds are valued and monitored on a much more frequent basis than bank deposits. Accordingly, in developing any further recommendations or guidance, it would be helpful if specific tailoring to the substance, form, risk profile and risk mitigants of the asset management sector were demonstrably reflected.

While the Central Bank considers the potential utility of concentration limits, it should be noted that such protections already exist to varying degrees across the EU regulatory and supervisory framework governing investment funds. Indeed, where appropriate, e.g., UCITS funds, counterparty limits also exist across legislation (while banks are also subject to certain counterparty limits). As such, we agree that further prescriptiveness in this regard could have a negative impact on asset liquidity, with related negative secondary impacts for investment funds. It is our strong view that the introduction of additional concentration limits would not strengthen the resilience of the funds sector, nor the broader financial market system.

The Central Bank discusses the notion that "*the levels of resilience for highly interconnected fund cohorts may need to be greater from a systemic risk perspective. That assessment of the interconnectedness of funds could therefore also inform the application of measures around liquidity mismatch and leverage of funds*[19]." As such, in seeking to better understanding the concept of interconnectedness, and the potential risks attached, policymakers should first seek to undertake system-wide analysis and, thereafter, stress testing, based on the information already reported by asset managers and other relevant financial market participants. The Bank of England, for example, has launched a system-wide exploratory scenario[20] with the intention of improving its "*understanding of the behaviours of banks and non-bank financial institutions during stressed financial market conditions*."

[19] Page 46 – Discussion Paper 11

[20] The Bank of England's system-wide exploratory scenario exercise | Bank of England

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

Answer 7:

7.1 Governance

We agree with the suggestion in the Paper that a global approach is necessary i.e., *"Globally co-ordinated standards are a necessary starting point for developing a macroprudential framework for the funds sector[21]."* The Discussion Paper further notes that *"The activation of measures in one jurisdiction without reciprocation in others, or different approaches to implementation across jurisdictions, may generate regulatory arbitrage[22]"* which is a viewpoint that we strongly agree with. The highly globalised nature of the funds market is likely to result in many local implementations of ex-ante macroprudential controls being circumvented, leading to a potential shift in vulnerabilities between jurisdictions.

7.2 Data

We agree that data acts as a key enabler for any macroprudential framework. Precise, comprehensive, and consistent data submissions will be critical to regulatory authorities in fulfilling their supervisory responsibilities in due course.

However, it is important that any additional reporting requirements focus on those data points that supervisors use consistently in their macroprudential analysis. For example, there was significant additional liquidity reporting to some NCAs, including the Central Bank, during the Covid-19 crisis which helped inform regulators how liquidity was being managed during a stress market period. We would also point to the fact that many NCAs require reporting of significant redemption capital flows, including the Central Bank of Ireland, with some asking for detail on how these flows are managed. Therefore, from a European perspective, it our view that there is already a significant volume of data provided, and as a starting point this data should be reviewed to remove the potential for duplicative reporting requirements. We would also point to the AIFMD/UCITS review which set regulatory expectations, for example, on reporting the availability of LMTs and the use of certain LMTs (focus on exceptional use basis). Any data collection recommendations would need to consider and align with these recent reviews and alignment with international data requests and coordination between NCAs should also be considered.

Additionally, we would note that this presents some significant challenges:

1. Agreeing the data to be collected will require coordination at international level, as well as national and regional levels. For example, European data can be difficult to obtain due to the fragmented nature of certain markets (e.g., fixed income) and therefore it is difficult to get full transparency of trading volumes, participation rates etc… in certain markets.
2. Defining the data to be collected will be challenging due to the variety of fund types, instruments, jurisdictions, valuations, volumes, fx rates and timings of data.
3. The quality of the data would likely present a challenge. ESMA have noted data quality challenges in their recent Annual Reports, and the 2023 annual work programme calls out "*enhancing the access to and quality of supervisory data*" as a priority. In addition,

[21] Page 47 – Discussion Paper 11
[22] Page 48 – Discussion Paper 11

the Central Bank also called out data quality as one of its key risks and areas of focus in its third Securities Markets Risk Outlook Report published on 2 March 2023.

4. Interpreting the data – under the assumption that data collection is coordinated, and no data quality issues exist – presents a significant challenge to identify where macroprudential measures may be warranted.

Finally, as referenced in question 5, Irish Funds would support the development of a European Consolidated Tape as a key initiative to help address some of the data difficulties currently faced within the European market.

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

Answer 8:

8.1 Costs

We would note that there are cost implications to the implementation of additional macro prudential measures which may be significant in nature. This includes the cost to the regulatory body for monitoring and reviewing the data and to the funds for calculating and maintaining the required data. All cost/benefit considerations and the impact on investors should remain at the forefront of any future developments. Therefore, it is welcome that the Central Bank reference the balancing of benefits and costs as one of their key principles.

8.2 Time to Implement

As with any new policy it can take a significant amount of time to design and implement and additionally the IT mechanisms required to be put in place to support the policy can also take significant time and investment to develop and maintain. In addition, while the policy is being prepared, other legislation may change, having an impact on the draft policy and may result in further adjustments needing to be made to the draft policy. We therefore welcome the Central Bank's reference to using "*adequate transition times or phased implementations*[23]" to address "*any potential cliff-effects associated with the introduction or adjustment of a policy*[24]."

8.3 Accounting Standards

Differences in global accounting standards can diversify the valuation methodologies of funds in different jurisdictions. Valuation methods specific to the macroprudential policy would need to be defined from the outset.

8.4 International Laws and Policies

Attempting to implement one global policy, where different countries have their own existing specific laws and policies, presents many complicated challenges from a legal perspective, and will require a large amount of research and detailed wording to allow the macroprudential policy address these challenges.

8.5 Operational Complexity

[23] Page 36 – Discussion Paper 11

[24] Page 36 – Discussion Paper 11

In our response to both the IOSCO and FSB consultations we highlighted the operational complexity that comes with implementing some of the suggestions within their draft guidance. Additional complexity can not only lead to increase operational risk but also to increase cost for the end investor. Therefore, we would contend that any policy implementation needs to consider its operationalisation and the cost implications of that complexity from the perspective of all fund stakeholders e.g., portfolio manager, administrator etc...

8.6 T+1 Settlement

The US and Canada are moving to a T+1 settlement cycle by May 2024. The move aims to tackle instances of market volatility, such as meme stock mania and the COVID-19 pandemic[25]. The European Securities and Markets Authority (ESMA), the EU's financial markets regulator and supervisor, today launches a Call for Evidence (CfE) on the shortening of the settlement cycle. Shortening the settlement cycle has many benefits for financial market participants—transitioning to T+1 can help firms improve operational efficiency, mitigate risk, and improve capital and liquidity utilisation. However, there is potentially an operational challenge in implementation which could increase complexity. Therefore, we would contend that any policy implementation needs to consider the impact of changes to the settlement cycle.

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[25] The dawn of T+1: how to prepare for a shorter settlement cycle, The Dawn of T+1 — Insight | PwC Ireland