Banc Ceannais na hÉireann
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INVESTMENT FUNDS SUPERVISION BULLETIN

DECEMBER 2024

Welcome to the first edition of the Investment Funds Supervision Bulletin, which complements our regular engagement with the funds sector. The purpose of this bulletin is to highlight current and future areas of supervisory and authorisation focus, including recent thematic and sectoral work to help firms to understand the risks identified.

We encourage firms to consider the content of this bulletin, and the actions they should take to address any identified risks. This bulletin should be read in conjunction with the Regulatory and Supervisory Outlook Report and all relevant Central Bank of Ireland (the Central Bank) publications and correspondence.

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Introduction

Investment Funds Sector Regulation

High quality regulation plays a vital role in supporting well-functioning markets. It ensures that investors are protected and that risks to financial stability are identified and mitigated. Regulatory interventions are intended to promote and safeguard the integrity of the funds sector and maintain confidence in the financial system. There is a direct link between effective regulation and ultimately better investor outcomes.

The Central Bank has designed its supervisory framework to support how it oversees compliance with both national and EU regulations, and this framework guides our enforcement of these regulations.

Investment Funds Supervisory Model

The Central Bank increasingly leverages data analytics, technology and supervisory intelligence to identify emerging risks or trends across the sector.

This approach leads to a more targeted, risk focused engagement with Fund Management Companies (FMCs), with a particular focus on underlying fund risks. Additionally, sectoral or thematic supervision continues to be a key component of our approach for supervising the Funds Sector, and this aligns with the Central Bank's strategy which includes the four core strategic themes referenced on the opening page of this bulletin. In implementing this approach, the Central Bank is seeking to transform into a more agile, resilient, diverse and intelligence-led organisation.

We have undertaken a number of thematic reviews over the last 18 months. These complement previous reviews and Common Supervisory Actions (CSAs) undertaken by the Central Bank and allow supervisors to build knowledge of particular themes, or conduct more targeted sectoral reviews across a range of FMCs and other Funds Service Providers (FSPs).

Recently completed thematic reviews

Fixed Operating Expense Models

As a follow on from the March 2023 industry letter that was issued in response to the CSA on Costs & Fees, supervisors conducted a targeted review of Fixed Operating Expense (FOE) Models.

This review assessed the prevalence of this type of fee model and whether it is being used in the best interests of investors. Supervisors also assessed the level of fee disclosure and transparency by FMCs.

Supervisors observed varying levels of fee retention by FMCs utilising FOE models. We identified shortcomings relating to the transparency of fee disclosures, and see scope to enhance the depth of the periodic review process to ensure the fee structure remains appropriate and in the best interests of investors.

What should FMCs do now?

The Central Bank expects that, where an FOE model is used to provide investors with protection and certainty with respect to the fees incurred, those investors should be fully aware of all expenses and the model should be calibrated so that any differential is minimised and that undue costs are not charged to investors.

We expect that all new and existing costs are reviewed annually, taking into account the investment objective and strategy of the fund, the target and actual level of performance achieved, and the role and responsibilities of service providers. Throughout the fund’s life, FMCs should ensure that the costs and fees are calculated fairly and equitably, serving the best interests of investors. This should be evidenced as part of the annual review process.

Periodic independent reviews of costs and fees structures should also be performed to ensure that they continue to offer investors a return commensurate with the fund’s risk profile.

The observations and findings identified in this review inform how we incorporate fee analysis into the funds authorisation process, to ensure FMCs have appropriate levels of fee transparency documented for investors. The results also provide important insights we can explore further as part of supervisory engagements with FMCs.

Recently completed thematic reviews contd.

Investment Advisors

This review, which commenced in 2023, was conducted following the CSA on Costs & Fees and was aimed at reviewing the instances where there is both an Investment Advisor (IA) and a discretionary Investment Manager appointed to a fund, and the relative fees being charged by both.

It also sought to determine the quality of the disclosures contained in the fund documents that details the role of IAs.

Supervisors observed instances where the fees paid to the IA were higher than that of the Investment Manager and in some cases the reasons provided by FMCs to justify these arrangements were not always clear. The review further highlighted concerns relating to the standard of fund document fee disclosures and the frequency of periodic fee reviews.

What should FMC's do now?

FMCs should ensure that fee arrangements are appropriate for the services provided and are reviewed throughout the lifecycle of the fund. As part of our fund authorisation process, the Central Bank is enhancing its assessment of the role of the IA and the fee model of the fund. It also continues to inform our supervisory engagements on the subject of costs and fees.

The Central Bank expects that the role performed by the IA is non-discretionary in nature and an adjunct to the role performed by the Investment Manager. With respect to the fees paid to non-discretionary advisors, FMCs should ensure that the fee arrangements are appropriate for the services provided.

FMCs are expected to ensure that the costs and fees are calculated in a fair and equitable manner to ensure that the best interests of investors are at the forefront.

The findings from this review may inform future supervisory engagement on the topic of costs and fees.

Other significant updates

Exchange Traded Funds (ETFs)

ETFs are clearly an area of interest for the Central Bank, given Ireland's prominence in that market within an EU context. We are acutely conscious of the European and global reach of Ireland's investment funds sector and ETFs.

The ETF market has grown at a rapid pace over recent years. Ireland has become the number one European domicile for ETFs, with more than 1,300 ETFs and approximately 67% of the European ETF market now domiciled here.

In 2024 the Central Bank carried out a review of how FMCs oversee the activities of Authorized Participants (APs) and Contracted Market Makers (CMMs) appointed to their ETFs. While the review highlighted some good practices, we also identified a number of areas where improvements are required in relation to oversight of the activities of APs and CMMs; this included areas such as due diligence, risk monitoring and stress testing, and the quality of Board reporting. The review found that, while the Irish ETF ecosystem is functioning effectively, there may be potential reliance and concentration on a small number of APs and CMMs. The findings from the review are set out in more detail in the Central Bank's industry communication issued on 28 November 2024.

Data Led Supervision

A key supervisory priority for the Central Bank is greater data utilisation and building out our data and analytic capabilities. Given the increasing importance placed on data by the Central Bank, FMCs should ensure data submitted to the Central Bank is accurate and reliable.

An example of this is the new Daily Investment Fund Return (DIFR) which, from 16 December 2024, will collect daily subscription and redemption data from all non-money market investment funds. This represents the first phase of daily fund return work; the next phase will focus on the collection of data in relation to the use of liquidity management tools.

This initiative supports the Central Bank in the effective and efficient oversight of the sector, our continued focus on the deployment of a data-led supervisory approach and increased visibility of the risk profile of this systemically important sector.

The DIFR will replace the current daily and weekly trigger based liquidity reporting and streamline current queries to industry. The Central Bank is also exploring ways in which we can aggregate data to share with industry.

Other significant updates contd.

Irish Property Funds

In order to help identify emerging trends within Irish property funds, the Central Bank issued a questionnaire to a sample of FMCs managing Irish property funds in Q1 2024. The questionnaire was qualitative in nature, seeking information on specific areas of interest in the real estate sector and gauging insights into current market conditions. The total combined Assets Under Management of the funds subject to the questionnaire was €28.59bn, with the funds having an average holding of 86% in Irish property assets.

There were two main findings from the supervisory analysis completed on the questionnaire responses that require action by relevant FMCs. We observed risk management practices where fund level Liquidity Stress Testing (LST) was absent, with a reliance being placed on the LST policy of the FMC. A reliance on the LST policy of the FMC is not sufficiently robust given it is not specifically tailored to the fund, its investment strategy and portfolio composition, which will differ for each respective fund. We also observed practices whereby LST carried out at fund level was not frequent enough. The determination of the frequency of a liquidity stress test of the fund should be based on the fund's characteristics, and the reasons for such a determination should be set out in the LST policy.

In terms of best practice the Central Bank, in line with ESMA Guidelines, recommend FMCs employ quarterly or more frequent LST, thus ensuring robust risk management frameworks are in place. FMCs are reminded that LST policies should be kept under continual review, and amended accordingly in respect of changes in the operating environment. Information gathered from this exercise will further influence our Irish Property Fund supervisory focus into 2025.

Other reviews with communications to follow

Liquidity Management Tools

Liquidity Management Tools (LMTs) are designed to reduce the potential for fund redemptions to disadvantage remaining investors thereby reducing or eliminating the first mover advantage and to enable FMCs to better manage redemptions. With this in mind, the Central Bank is carrying out a deep dive review of LMTs in order to develop an increased understanding of how FMCs use LMTs during "normal" market conditions and during more volatile market conditions; the review is also considering the governance around how and when LMTs are used.

An initial quantitative survey was issued to all FMCs earlier this year, with relevant information submitted over the course of Q3. The initial analysis of this information was completed in Q4 and indicated that there is a lack of alignment between the current availability of LMTs and the level of availability being considered as part of international discussions on LMT guidelines for investment funds.

The initial analysis also indicated that usage levels of price-based LMTs during the survey period were lower than we would have expected. Swing pricing was observed to be the most used price-based LMT, followed by a smaller proportion of funds stating they used an anti-dilution levy. Size of fund and FMC preference appear to be the largest determinants of which price-based LMT is used. Initial analysis also indicated that the existence of more mature governance arrangements resulted in higher levels of price-based LMT usage; for example, greater usage was observed where a fund had ex-ante thresholds that were regularly reviewed.

Early in 2025, we plan to commence the next phase of this review, which will see a more targeted questionnaire issued to a sample of FMCs. It is the intention to conclude this review in 2025 and communicate our findings to industry.

A look to the future

Risk Register

The Central Bank conducted a review of a number of Depositaries and Fund Administrators earlier this year. The primary focus of the review was to assess the practices surrounding the use and management of Risk Registers. This included a review of risk assessment methodologies and risk reporting (including emerging risks), while also considering if firms were utilising entity specific risk taxonomies and risk control self-assessments. Supervisors will engage directly with firms to address any specific findings identified in due course. The information gathered from the review will also inform how supervisors assess and benchmark risk management frameworks across the sector.

Securities Lending Review

This review commenced in Q1 2024, and examined the compliance of UCITS and AIF securities lending arrangements with ESMA Guidelines. The review assessed if securities lending fee arrangements are calculated in a fair and equitable manner, are clearly disclosed and are regularly reviewed. The Central Bank anticipate concluding this thematic in 2025 and plan to communicate our findings and actions to industry.

Common Supervisory Action (CSA) on Sustainability Risks and Disclosure

The European Securities and Markets Association (ESMA) identified this theme for all National Competent Authorities, which included the Central Bank. The purpose of this CSA was to assess FMCs compliance with the Sustainable Finance Disclosures Regulation. It is expected that ESMA will issue its CSA report in Q2 2025 and the Central Bank will also share an industry communication following ESMA's publication.

Here are some examples of other sectoral work due to conclude in the coming months.

A look to the future contd.

Looking Forward

The Central Bank will continue to adapt its regulatory approach in 2025. The risks and trends presented in the Central Bank's Risk Outlook Report will guide our risk-focused, data led approach to fund supervision. The Irish funds sector continues to grow in size and complexity, and consequently, we need to ensure our supervisory approach remains fit for purpose.

In that regard, cohort and sectoral supervision provide a high degree of flexibility in addressing and reacting to current and emerging risks, in addition to the work undertaken by our day-to-day funds supervision teams.

Some areas of focus for 2025 will include a new ESMA CSA topic, continuation of the LMT review, a review focusing on Hedge Funds and the recently issued ESMA Costs and Fees Survey. There may also be further thematic reviews launched during 2025. The Central Bank will continue to engage with the funds industry to manage the timelines and expectations relating to this work.

From an authorisations perspective, we will continue to perform comprehensive authorisation assessments and post authorisation amendments of retail investment funds. An area of focus will be the Sustainable Finance Disclosure Regulation, in particular ESMA Guidelines on Funds names using ESG or sustainability-related terms, which applied from 21 November 2024 for new funds and will apply from 21 May 2025 for existing funds. Quality Assurance reviews will also continue to be carried out post authorisation on a sample of qualifying investor AIFs and all qualifying investor and professional investor ELTIFs.

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