Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Feedback Statement

Discussion Paper 11: An approach to macroprudential policy for investment funds

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Introduction

The Central Bank of Ireland's Discussion Paper on an approach to macroprudential policy for investment funds (DP11) presented an overview of key considerations for developing and operationalising a macroprudential framework for the funds sector, given its growing importance for the functioning of the financial system and real economy. It was designed to engage stakeholders, domestically and internationally, in order to further advance the policy discussion in this area.

This Feedback Statement provides an overview of the written submissions received and a discussion of the key issues articulated by respondents to the Central Bank of Ireland's (hereafter 'the Central Bank') Discussion Paper on an approach to macroprudential policy for investment funds (DP11). In total there were 15 written responses received to the Discussion Paper, mainly from the regulated funds sector.[1] The Feedback Statement summarises the feedback provided in the written responses. It also provides an overarching response to the key themes within the feedback provided by stakeholders (see **Box 1: Central Bank response to written feedback received)**.

In addition to reviewing the written feedback received, the Central Bank also engaged with a range of stakeholders, including other central banks, securities regulators, international institutions and industry participants, such as industry associations, on the key issues raised in the Discussion Paper. The main themes from these bilateral engagements are outlined in **Box 2: Summary of bilateral stakeholder engagement on an overarching macroprudential framework for investment funds**.

Beyond these bilateral engagements, the Central Bank also hosted a high-level international conference on macroprudential policy for investment funds in May 2024, as a follow-on to the publication of the Discussion Paper. The international conference provided a further opportunity for the Central Bank to engage with both domestic and international stakeholders on some of the key issues outlined in the Discussion Paper. The key themes of the Central Bank conference are outlined in **Box 3: Key themes from Central Bank conference on macroprudential policy for investment funds**.

[1] Annex A includes a list of the written respondents to DP11.

The Central Bank appreciates the feedback received across written responses, bilateral engagements, and as part of the May 2024 international conference. It is clear that there are still some divergent views on the approach to strengthening the macroprudential perspective in the oversight of the sector. The Central Bank considers that the feedback received to the Discussion Paper helps to inform our own thinking as well as to contribute to the wider international debate on the macroprudential framework for the funds sector. In light of the ongoing international work on macroprudential policy issues for funds, stakeholder feedback on a number of issues raised in response to the Discussion Paper will form part of Central Bank deliberations, as further analysis and policy work is conducted in this area.

As outlined in DP11, the process for introducing a macroprudential policy framework for the funds sector is starting from a different place to where the same debate originated in relation to the banking system. It represents a new perspective in the oversight of the funds sector, complementing the traditional focus on investor protection. As such, it is to be expected that the development of a macroprudential framework for the funds sector will take time. Indeed, as with financial regulation more generally, a macroprudential lens in the oversight of the funds sector will always need to adapt and evolve, reflecting changes across the sector and financial system more broadly. In that context, DP11 represents an input into this long-term project by outlining a number of issues which need to be considered when developing and operationalising a macroprudential framework for the funds sector internationally.

In terms of next steps for this work, and given the global nature of capital markets, one of the main areas of focus for the Central Bank is actively contributing to various international workstreams on developing the macroprudential approach to investment funds. A key focus for the Central Bank in the near-term will be contributing to the European Commission's consultation on a macroprudential framework for non-bank financial intermediation (NBFI), which seeks stakeholders' views on the adequacy of the current framework. More broadly, the feedback received to DP11 will assist the Central Bank in contributing to the wider international work, including at the FSB and IOSCO, on macroprudential issues for funds. For example, the Central Bank is actively participating in international workstreams on NBFI (including funds) leverage and follow-up work on open-ended fund (OEF) liquidity issues.

In order to support international work led by the FSB and IOSCO on liquidity risk management in OEFs, the Central Bank is undertaking work domestically to understand better how price-based LMTs are used by Irish-domiciled funds, as well as exploring in more depth some of the key implementation challenges, including on issues such as incorporating the market impact of asset sales into swing factors;

understanding any inconsistencies in the use of these tools; and understanding the use of such tools in normal as well as stressed conditions.

Domestically, the Central Bank will also continue to evaluate the ongoing implementation and monitoring of two macroprudential measures introduced for specific cohorts of investment funds in Ireland – namely measures pertaining to Irish authorised property funds and Irish authorised GBP-denominated liability driven investment (LDI) funds. Beyond this work, the Central Bank will continue to actively monitor the sector, including to track the evolution of financial vulnerabilities across different fund cohorts. The Central Bank will also continue to deepen its understanding of the nature of systemic risks in the funds sector through ongoing analysis and research.

Progress on these aforementioned pieces of work will proceed at different speeds and will require different forms of engagement, including with a range of international and domestic stakeholders, depending on the issue being addressed. As such, and in line with the principle that a 'one-size-fits-all' approach to the funds sector is not appropriate, progress in developing and operationalising the macroprudential lens in the oversight of the funds sector will occur across a number of different dimensions over the coming years.

Overview of DP11

The Discussion Paper outlined why a macroprudential perspective is needed for the funds sector. In doing so, it highlighted the increasing relevance of the sector for the global financial system and the financing of the real economy. It outlined the systemic risk posed by the sector and how – in the face of financial vulnerabilities – it is typically the collective action of funds that has the potential to generate this risk. It also highlighted that while the current investor protection-focused regulatory framework for the funds sector can help to address some fund-specific elements of systemic risk, it does not fully address them all.

The paper outlined the objectives and principles underpinning the macroprudential approach for the funds sector. Broadly speaking, the key aim of macroprudential policy for the funds sector would be to ensure that this growing segment of the financial sector is more resilient to stresses and less likely to amplify adverse shocks.

The Discussion Paper also set out principles that should underpin the design of a macroprudential framework for funds, including that: (i) resilience-enhancing

measures should target fund cohorts; (ii) resilience should be built before crisis conditions occur; (iii) policy measures could either seek to limit underlying vulnerabilities and/or be targeted at the interconnectedness of the sector; (iv) policies should seek to have a degree of flexibility over time; (v) policy intervention should be the result of a careful balance between costs and benefits for the broader economy; and (vi) global coordination is a critical enabler to macroprudential policy for funds and macroprudential measures should take a system-wide perspective to guard against the possibility that risks shift to other parts of the financial system.

The Discussion Paper also outlined a range of potential macroprudential tools that could be employed to mitigate financial stability risks in the funds sector. These could include the re-purposing of existing tools or potentially the development of new, bespoke macroprudential tools. Finally, DP11 outlined some key considerations for operationalising a macroprudential framework for the funds sector, including the need for international coordination and the importance of data when developing and operationalising a macroprudential framework for the funds sector.

Summary of stakeholder written responses to DP11

The Central Bank thanks all stakeholders who took the time to make a submission to DP11. The insights provided by the feedback will feed into Central Bank deliberations on a potential macroprudential framework for investment funds. While the feedback received was wide-ranging, a number of key themes emerged through the written feedback. The Central Bank's perspective on these themes is summarised in Box 1: Central Bank response to written feedback.

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

While respondents acknowledged that the risks outlined in the Discussion Paper can be systemic in nature, they noted that investment funds are only one part of a wider financial system and do not generate more systemic risk than other actors. In addition, some respondents highlighted that liquidity and leverage risks are not unique to the funds sector. It was also noted that while actions of the investment fund industry may not always be optimal from a financial stability perspective, given prevailing market conditions, funds primarily act on behalf of their investors. One respondent noted that investment funds are minority investors in most markets, and account for less than a third of global financial assets, and open-ended funds are a subset of the assets that they manage. Respondents generally agreed with the Central Bank's view that investment funds are different to banks and given the diverse nature of the funds sector, a 'one-size-fit-all' approach would not be optimal when considering macroprudential policy for this sector.

Some respondents acknowledged that leverage, liquidity mismatch and interconnectedness, if not managed properly, can pose risks to financial stability. However, other respondents noted that liquidity risks posed by funds are not substantial and that current EU policy requires an alignment between the liquidity of assets held by investment funds and the dealing terms, while also facilitating LMTs to manage liquidity mismatch. There was some recognition, however, that further actions

could be taken to facilitate greater use of these tools. On liquidity risks, one respondent noted that policies should target first-mover advantage within funds, but not first-mover advantage in markets (i.e.

that investors within a fund who redeem shares first do so on more favourable terms than those who redeem later). One respondent noted that first-mover advantage in markets will continue to exist irrespective of investment vehicle, whether direct investments, investments via separate accounts, or investment funds. Another response suggested that private funds are limited users of leverage and that its use by private funds was effectively risk-managed by funds and their counterparties.

Many respondents noted that policies to address systemic risks should not be limited to reducing liquidity demand spikes but should also target an enhancement of the resilience of liquidity supply in stress. Those respondents outlined a view that reforms introduced post-global financial crisis (GFC) have reduced banks' balance sheet intermediation capacity in key asset classes.

Some respondents also noted leverage risks have been dealt with through existing regulation and therefore new macroprudential policies are not required to mitigate this risk. It was also noted that competent authorities should not view leverage through the same lens for each type of investment fund, but instead assess whether the leverage employed is appropriate for a specific investment strategy.

Additionally, concerning interconnectedness, it was mentioned in the responses received that policymakers should consider what constitutes 'excessive' withdrawal of credit and when 'impairment' of financial services occurs. Counterparty risks should be assessed and there should be ample consideration given as to whether risks are created by a specific type of fund, or by a specific investment strategy in general.

Some respondents stated that the funds sector does not add any further risk to the financial system as a whole. Another respondent noted that the assessment of systemic risk from the funds sector is still evolving, and therefore, in order to avoid any unintended consequences, it is critical to ensure that the potential issues and challenges with a future macroprudential policy framework are well thought out, evidence-based, and appropriately and rigorously stress-tested. It was also noted by one respondent to make a distinction between systemic risk and price volatility in markets when considering risks in the investment funds sector. Another respondent did not agree with the discussion on the potential channels for systemic risk in regulated funds as set out in the Discussion Paper.

One respondent also explicitly highlighted the costs of macroprudential policy through lower returns on investment to the ultimate investors, which could often be insurers and pension funds. Macroprudential policy could therefore create externalities which authorities should evaluate in their policy design.

Some respondents highlighted the need for more analysis of the mechanisms through which systemic risk is transmitted to the rest of the financial system and real economy, while one respondent did not agree with the Central Bank's position that the economic frictions that exist in funds can result in excessive ex-ante leverage or liquidity mismatch in funds.

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?

Most respondents to the Discussion Paper expressed the opinion that context is vital when considering whether it is the collective action of investment funds that generate systemic risk. The responses generally outlined that investment funds are agents of their investors and, as a result, act in line with their investors' preferences. Moreover, some responses noted that movements in the markets in which investment funds operate will affect investment funds in the same way as it does other agents in the market. Moreover, one respondent questioned the assertion that the actions of investment funds are disproportionately affecting markets and their dynamics.

Some respondents did agree in principle that similar actions can be taken by investment funds of the same type and strategy at a given point in time. Some respondents also noted that more evidence is needed to conclude that investment funds' collective actions are the cause of the build-up of systemic risks. Given the significance assigned to the collective actions of funds in the Discussion Paper, a few respondents noted a deeper analysis on such dynamics should precede the evaluation of policy options by the Central Bank.

The investment fund sector includes a large number of funds with different investment strategies and fund structures, as highlighted in a number of responses. As a result, respondents noted that whether actions are truly a 'collective' response is debatable. Therefore, some respondents recommended assessing 'collectiveness' on a fund cohort-by-cohort basis. Others raised questions about cohort-level analysis and suggested DP11's consideration of investment funds as a source of potential systemic risk did not take into account the behaviour of other market participants.

Further to this, some respondents noted that the upstream effects of macroprudential policies on the ultimate investors need to be taken into account when formulating policies. Such investors will likely be other financial institutions, such as insurers and pension funds, which may be adversely affected if policy is unduly impeding their investment objectives.

A respondent suggested that grouping funds by cohorts does not consider the investor base, which is what ultimately drives liquidity demand, while another respondent noted that it is a flawed premise to think that funds all behave in the same way during a crisis. One response put forward that the cohort concept was insufficiently defined, with this definition possibly changing over time, and that the cohort concept did not account for the fiduciary relationship between fund managers and investors.

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?

Some respondents did not agree with the view that the regulatory frameworks for investment funds were primarily developed for investor protection rather than financial stability purposes, with many respondents expressing the view that some of the provisions contained in EU regulatory regimes can also have a positive macroprudential impact. A number of examples were given in this regard, such as the view that flexibility in the use of LMTs may have prevented the amplification of shocks. Some respondents did agree that the current regulatory framework has been primarily designed from an investor protection perspective, but caveated that it does not mean it is ineffective for mitigating financial stability risk.

Some respondents noted that the current regulatory framework has been sufficient to reduce the propensity of certain fund cohorts to amplify shocks. It was suggested that the current blend of micro and macro supervision, and the large volume of data provided to authorities has proved largely effective in preventing the build-up of systemic risk across the sector. One respondent supported the view that policymakers must consider the broader ecosystem and welcomed a macroprudential focus, however they questioned the need for significant changes through additional macroprudential policy measures. In general, there was some support for the view that some features of existing frameworks may not be optimal from a macroprudential perspective, with examples provided in relation to money market funds (MMFs). One

respondent noted that it is not that the current regulatory framework is insufficient to reduce the propensity of certain fund cohorts to amplify shocks, but rather it is the impact of the rigidity of existing rules which can have this effect.

A number of respondents questioned the grouping of funds into cohorts, particularly without robust analysis, with one respondent proposing groups based on risks from use of particular products and activities, rather than grouping solely by fund cohorts. The importance of the centralisation and use of data and information transmitted by Alternative Investment Fund Managers (AIFMs) under the Alternative Investment Fund Managers Directive (AIFMD) for financial stability purposes was highlighted by a number of respondents.

The latest review of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and AIFMD was welcomed in terms of anti-dilution tools that mitigate first-mover advantage and leverage limits for UCITS funds. It was noted that regulators could further support more widespread use of anti-dilution tools by ensuring that investment managers are operationally prepared to deploy those tools and have appropriate contingency plans in place for managing extraordinary market conditions. On AIFMD more generally, one respondent suggested leverage in pockets of the fund sector could be successfully targeted in extreme situations through existing tools under AIFMD. The FSB work on leverage (as part of the FSB's NBFI work plan) was also welcomed.

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?

A number of respondents welcomed the acknowledgement by the Central Bank that a macroprudential framework for funds cannot purely be an extension or replication of the macroprudential framework applied to the banking sector. Some respondents noted that a macroprudential perspective could enhance the resilience of the funds sector. However, other respondents did not agree that the funds sector represents a unique risk to financial stability and suggested that macroprudential policy is based on bank-centric concepts and is therefore not suitable for the funds sector.

Respondents also welcomed the Central Bank's acknowledgment that policy interventions should strike a careful balance between economy-wide costs and

benefits, while many also noted that international coordination will be critical to the successful adoption of any macroprudential framework.

Some respondents urged the Central Bank to take account of the progress made at the international level on liquidity and leverage in funds and to consider whether any additional financial stability concerns can be addressed through a targeted strengthening of the current regime of fund regulation, instead of adding a new macroprudential layer on top of existing regulation. Some responses favoured a regulatory focus on risks arising from specific products and activities, taking account of the heterogeneity in the funds sector.

A number of responses mentioned the need for robust data to improve risk assessments and to accurately identify risks in specific cohorts while some respondents noted that further evidence is needed that funds contribute to systemic risk before introducing macroprudential policy for funds.

Many respondents welcomed the acknowledgement by the Central Bank that the primary responsibility for risk management in the funds sector rests with the fund managers and noted that activation of any LMTs should be the responsibility of the fund managers, other than in exceptional circumstances.

A number of respondents suggested policymakers should focus more on liquidity supply and broader market liquidity issues, particularly since the reforms in the wake of the GFC where liquidity has become highly constrained in times of stress. Some respondents mentioned the potential for unintended consequences from over-regulating the sector - in particular if assets were to move to unregulated vehicles giving regulators less oversight and control.

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 additional potential tools that could be explored?

Overall, a number of respondents agreed that a ‘one-size-fits-all’ approach to developing macroprudential policy for funds would not be appropriate, given the heterogeneity in investment funds’ business models.

Respondents raised concerns that tools used to manage liquidity at the fund level can be effective from a macroprudential perspective. However, it was acknowledged that

any proposed tools should be outlined in detail before a determination of suitability can be accurately made.

Many respondents felt that the best approach for the funds industry would be to build on the already existing guidance developed over recent years, seeking to further promote the availability and use of LMTs in particular, but without making their use prescriptive in nature. This was based on the view that fund managers are best equipped to assess risk, and that incentives (to act in the best interests of the funds and their investors) is also aligned with macroprudential goals. A strong emphasis was put on allowing managers' flexibility in deciding when and which tool to apply. Some respondents, however, noted that the macroprudential benefits of tools developed for microprudential or investor protection purposes should not be discounted, and should be examined further.

Respondents in particular did not support the FSB and IOSCO emphasis on the incorporation of market impact into the calibration of anti-dilution tools and noted this as evidence that a prescriptive use of standardised anti-dilution models would not be appropriate. It was suggested that authorities should set expectations for fund managers to use a mixture of quantitative and qualitative factors when determining the liquidity of fund assets in normal and stressed market conditions within the context of a liquidity framework set out by authorities.

It was also noted that not all fund service providers may be able to adequately incorporate a swing pricing model. In addition, some respondents pointed to the FSB's recognition of the limitations of anti-dilution LMTs, specifically that they "might not reduce redemptions driven by other factors such as 'dash-for-cash' or 'flight-to-safety'". Taking all of this into account, an overall preference was outlined by respondents that regulators should be supportive of providing a wide range of LMTs for funds to use at their discretion.

Some respondents noted that, within the FSB and IOSCO work, swing pricing is not 'elevated' above other suggested anti-dilution LMTs, which also includes valuation revisions; dual pricing; anti-dilution levies and subscription/redemption fees. Whichever tool is chosen, it was noted that this should be tailored specifically to a funds' portfolio and investor base. In this regard, respondents highlighted that local fund administrators and their respective oversight entities are best placed to do this. The application of swing pricing was noted to require 'judgement and expertise' across a range of asset management functions, and is dependent on market conditions and individual fund flows, which again speaks to it not being a prescribed process, according to respondents.

Some potential unintended consequences of using LMTs as macroprudential tools were also outlined by respondents. Namely, it was suggested that prescriptive use of some LMTs could potentially create incentives for investors to 'run' which currently do not exist, while others could incentivise investors to hold the same assets in unregulated vehicles and products, which could lead to an increase in financial stability risk (due to lower investor protection) rather than a decrease. This is reflective of a broader theme which is prevalent within the written feedback to DP11 which draws attention to 'level playing field' concerns i.e. any swing factors which are deliberately in excess of actual liquidity costs have the potential to constrain retail investors' access to markets, vis-à-vis institutional investors with a larger range of investment vehicles to choose from, or the aforementioned investors which instead choose to invest in unregulated vehicles to avoid additional costs.

Finally, a key area of focus identified by most respondents is the need to improve data availability and collection with regard to LMT usage. It was noted that this has steadily developed over recent years, and that a continuation of that trend is required in order for risks to be adequately and accurately identified in the coming years. An increase in granular data on end investor types is highlighted as a particular area for improvement, with one respondent suggesting that the Central Bank should engage with other regulatory authorities to take a global, coordinated and activity-based approach to address systemic risk that fund data demonstrates is present.

Some respondents highlighted that, as funds employing leverage are already subject to a defined set of rules and extensive reporting requirements, there would be concerns on additional regulations to leverage, including leverage limits. By contrast, other respondents noted specific and narrowly targeted leverage restrictions could be viable options. Respondents underlined that tools to monitor risks associated with leverage exist, one being stress testing. However, it was widely recognised that the lack of consistent and comparable global and domestic data, and of harmonisation in how leverage is calculated, are impediments to assessing potential risks associated with the use of leverage.

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

There was an acknowledgement by a number of respondents that the interconnectedness of funds deserves further analysis and scrutiny. However, respondents noted that in order to better understand the concept of interconnectedness, and the potential risks attached, policymakers should first seek to

undertake system-wide analyses before moving to any policy considerations that could target interconnectedness.

Regarding the suggestion that concentration limits could potentially be considered to limit the spillover and contagion risks from interconnectedness, one respondent would welcome further clarity on how these would work. Another respondent noted that these limits already exist to varying degrees across the EU regulatory and supervisory frameworks governing investment funds, and as such, further prescriptiveness in this regard could have a negative impact on asset liquidity, with related negative secondary impacts for investment funds.

Regarding margining practices, one respondent noted that investors' ability to prepare for margin calls could be enhanced. As such, policymakers should ensure central counterparties (CCPs) size initial margin requirements more conservatively, using appropriate model assumptions to mitigate the potential for future pro-cyclical initial margin moves. A number of respondents noted that post-GFC margining requirements have resulted in a trade-off between counterparty credit risk and liquidity risk.

Some respondents supported further supervisory engagement on potential issues related to interconnectedness. A number of respondents did not agree with the focus on the concept of interconnectedness in DP11, citing a lack of evidence that the collective actions of funds or their interconnectedness can generate systemic risks.

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

Most respondents generally agreed that international coordination is necessary in developing a macroprudential framework for investment funds to ensure consistency across jurisdictions. Most respondents agreed that the activation of measures in one jurisdiction without reciprocation in others, or multiple approaches to implementation across jurisdictions, may generate regulatory arbitrage. In addition, respondents stated that macroprudential policy should not target the funds sector specifically, and that any financial stability discussion needs to take into account the broader non-bank financial intermediation ecosystem and its links with the rest of the financial sector. Respondents also acknowledged the ongoing workstreams at IOSCO and the FSB in the area of investment funds.

Respondents noted that the regulatory frameworks for investment funds, including AIFMD, had financial stability as a key objective, alongside a significant investor

protection component. Some responses referenced the expansion in financial regulation after the GFC, including in the funds sector. Other respondents noted that regulated fund structures do not create unique risks to financial stability compared to investors who directly invest in markets. Some responses highlighted the relationship between investor protection and financial stability with some submissions noting that investor protection and financial stability are complementary objectives. Respondents agreed with the point outlined in DP11 that it is not the aim of macroprudential policies for non-banks to replace or substitute for funds' or investors' own risk management practices.

Respondents noted that data would be a key enabler for macroprudential policy and that competent authorities should seek to ensure data reported through existing frameworks is shared to avoid excessive reporting burdens on funds. Responses noted that fragmented data requirements could limit the effectiveness of macroprudential policy and increase associated costs for industry. Respondents also noted challenges associated with data, including the quality of data, as well as defining the data to be collected and ensuring it is used to develop a comprehensive picture of market activity. Some responses put forward that there should not be a need for greater levels of data collection from funds until it is clear that this data is not available elsewhere, e.g. through counterparties such as banks and prime brokers. One response noted that data should be protected in terms of ownership, use and disclosure.

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

Responses on whether additional issues need to be considered when operationalising macroprudential policy for funds covered a variety of issues. Some responses focused on particular fund sectors, such as real estate and private funds, while other responses discussed specific technical elements associated with implementation.

One respondent noted that additional macroprudential measures might have significant cost implications, both for regulatory authorities and investors. Additional issues raised beyond governance and data considerations included ensuring adequate transition periods or phased implementations; defining valuation methods specific to macroprudential policy; different legal perspectives across jurisdictions; operational complexity associated with policy implementation; and the movement to T+1 settlement in the United States and Canada.

Other responses noted the balance in terms of adherence to regulation for portfolio managers, in contrast to individuals participating directly in the market. Another response put forward that global regulatory reforms, combined with improved risk management at both the dealer and investment fund level, had reduced the likelihood of an event being caused by a single fund, like that of Long-Term Capital Management as noted in the Discussion Paper.

One response noted that possible future consequences of a surge in mergers and acquisitions of asset managers and consolidation of retail investment company platforms might be underestimated in the context of fund holdings, concentrations, and consequent volatility and potential market outcomes that may have systemic risk implications.

Central Bank response to written feedback

Systemic risk and cohorts of funds

The Central Bank agrees that investment funds are only one part of the financial system and are not the sole source of systemic risk outside of the banking sector. This was also highlighted in DP11. In the Central Bank's view, however, across different episodes in recent years, vulnerabilities within cohorts of the funds sector have contributed to amplification of adverse shocks in core financial markets. These episodes, coupled with the strong growth of the sector and its importance in overall financial intermediation, have underpinned the increased level of focus on the sector from the international regulatory community. As an integrated regulator of one of the largest fund hubs globally, which has mandates across both investor protection and financial stability, it is important that the Central Bank is contributing actively to the international debate on the evolution of the regulatory framework, and taking direct action where required.

The Central Bank recognises that focusing on cohorts of funds and the systemic risk that they can generate in light of financial vulnerabilities is a new perspective in the oversight of investment management. Traditionally, the perspective has been to focus on risk management by individual fund managers relating to investor protection. When vulnerabilities such as leverage and liquidity mismatch are present in funds, fund managers may resort to asset sales in response to a shock. From an individual perspective, asset disposals in stressed market conditions can be a rational response. Systemic problems can arise, however, when collectively many fund managers are having to sell, contributing to market disruption. While the Central Bank acknowledges that decisions taken by individual fund managers in response to shocks are often rational at an individual level, these decisions can generate negative spillover effects when aggregated across entire *cohorts of funds*. Therefore, a macroprudential perspective focused on this systemic dimension is warranted to complement an investor protection focus.

The Central Bank acknowledges that fund managers are well positioned to manage the liquidity of their funds at an individual level. However, it is likely not a reasonable expectation that managers take a system-wide approach, which takes the collective actions of similar funds into account before making decisions. The Central Bank's view, therefore, is that there is a role for authorities to identify the need for, and

develop, a macroprudential perspective in the oversight of the sector to address such system-wide concerns.

Finally, the Central Bank believes that that the investor protection perspective and the macroprudential perspective are not mutually exclusive and, rather, are entirely complementary.

No ‘one-size-fits-all’ approach to macroprudential policy

Macroprudential policy is often discussed in the context of the existing banking framework and what has been achieved in this area since the GFC. Although there are some lessons that can be taken from this work, it is the Central Bank’s view that a macroprudential framework for funds cannot be delivered by applying the macroprudential framework for banks to the funds sector. For example, bank-like capital requirements are not appropriate for the nature of the systemic risk posed by fund cohorts. The framework should be bespoke to the nature of the systemic risk from fund cohorts. Taking into account the diversity of the sector, it is clear that a ’one-size-fits-all’ approach is not appropriate.

Benefits and costs of macroprudential policies

The Central Bank welcomes the feedback received on the need to consider the benefits and costs of macroprudential policies and agrees that this is an important issue in the development of a macroprudential approach for the funds sector. The Central Bank agrees that, as with any policy intervention, there is a need to consider both the economy-wide costs and the benefits of policies, and also the uncertainty surrounding the impact that policy measures might have, including any potential unintended consequences.

This is an area the Central Bank will continue to deepen its understanding and knowledge. The development of macroprudential policies for this sector, including the assessment of potential benefits and costs, will need to be informed by a range of evidence. This includes quantitative and qualitative information, and ultimately will also need to be guided by the judgement of policymakers. A single model to weigh-up all the benefits and costs of policy action quantitatively does not exist. It is also important to acknowledge that potential benefits of policies are usually less visible and difficult to quantify, and therefore policymaker judgement will be required when weighing up potential benefits and costs of policy measures. On this basis, the Central Bank believes regular monitoring of macroprudential measures is important

to ensure that they are achieving their macroprudential aims and that they are not imposing undue burden on market participants or on the broader economy.

Importance of international coordination, governance and data

The Central Bank is actively involved in the international and European work ongoing on this topic currently and reiterates its support for the various workstreams that are ongoing. At a global level, the FSB has published revised recommendations on liquidity risk management for OEFs. It is now critical that implementation of these recommendations is prioritised, including in Europe. This will entail some challenging implementation dimensions. For example, it is important to ensure that managers use anti-dilution appropriately, and that any significant market impact of sales is consistently taken into account, which is important from a financial stability perspective. The focus of FSB policy deliberations is now on leverage in NBFI more broadly, which in many ways is a more challenging policy area, but equally critical, and one where the Central Bank is actively participating and supporting the work.

The Central Bank welcomes the opportunity to feed into the European Commission's on-going consultation on addressing the adequacy of macroprudential policy for NBFIs. This presents an important opportunity to strengthen the regulatory framework in relation to the funds sector and also NBFI more broadly across the EU.

A common theme in the feedback to DP11, and which is also evident in the European Commission consultation report, is the issue of data. Robust data is a necessary building block to strengthen regulators' collective understanding of the fund sector's contribution to systemic risk. The Central Bank firmly supports the development of a framework that facilitates data sharing between national authorities for macroprudential risk assessment. Such a framework would require coordination at regional, national and international levels to ensure robust data quality and data sharing agreements. New data collections may be necessary, however ensuring the sharing, usability and high quality of existing data collections is also a priority.

Other issues to be addressed include international coordination, reciprocation of macroprudential measures and how such a reciprocation framework could be implemented in the investment fund sector. International coordination and cooperation would be optimal in the context of specific policy or supervisory interventions as demonstrated by the recent aligned introduction by the Central Bank and Commission de Surveillance du Secteur Financier (CSSF) of macroprudential measures for GBP-denominated liability driven investment (LDI) funds in Ireland and Luxembourg. Regarding governance, and in order to function

effectively, a macroprudential framework would ideally have a high degree of consistency internationally, including a reciprocation framework. The introduction and calibration of specific macroprudential tools in one jurisdiction can have impacts in other jurisdictions. Without reciprocation, there is a risk that regulatory arbitrage could arise which could limit the effectiveness of any intervention and could result in a shift of underlying vulnerabilities across borders.

Next steps

The aim of the Discussion Paper was to advance the discussion of key considerations for developing and operationalising a macroprudential framework for the funds sector. The feedback received helps to inform the Central Bank's thinking as well as contribute to move forward the wider international debate on this topic.

One of the main areas of focus for the Central Bank in the coming years is actively engaging in the various international work to strengthen resilience of the NBFI sector, including funds. This is because capital markets are inherently interconnected and global in nature, and is consistent with the principle that an internationally-coordinated approach is optimal. In this regard, it is important that the focus now shifts to the implementation of the FSB recommendations and IOSCO guidance on liquidity management for open-ended funds, and the Central Bank will support work at a European level to implement these liquidity recommendations. The Central Bank will also continue to play an active role in work underway at the FSB on leverage in NBFI (including funds). An additional key focus for the Central Bank will be contributing to the European Commission's consultation on a macroprudential framework for non-bank financial intermediation, which closes in late-2024.

At a domestic level, the Central Bank will continue to monitor the ongoing implementation and effectiveness of two macroprudential measures introduced in Ireland under the third pillar of the Central Bank's macroprudential framework in relation to non-banks. The two sets of macroprudential measures cover Irish authorised property funds and Irish authorised GBP-denominated LDI funds, the objective of which is to address financial stability concerns with Irish property funds, and to ensure the resilience of GBP-denominated LDI funds. An important element of this work involves evaluating the impact of the measures, including any potential unintended consequences. Additionally, in order to support aforementioned international work on liquidity risk management in OEFs, the Central Bank is undertaking work domestically to understand better how price-based LMTs are used by Irish-domiciled funds, as well as exploring in more depth, some of the key

implementation challenges to inform operational discussions internationally on this issue.

The Central Bank will also continue its work in actively monitoring the funds sector, including to track the evolution of financial vulnerabilities across different fund cohorts. Through research and analysis, and efforts to improve data quality and data availability, the Central Bank will continue to deepen its understanding of the nature and magnitude of systemic risk in different parts of the funds sector.

NBFI risks are also increasingly cross-border in nature, and it is important that efforts are made to ensure greater cross-border data sharing, and to ensure progress is made towards developing an effective reciprocation framework. The work on developing a macroprudential framework for the fund sector will remain a priority for the Central Bank in the years ahead, working with our peers internationally and through our engagement with the sector domestically.

Summary of bilateral stakeholder engagement

Bilateral stakeholder engagement on an overarching macroprudential framework for investment funds

The Central Bank engaged with a range of stakeholders, including other central banks, securities regulators, international institutions and industry participants, such as industry associations, during the feedback period. In general, engagement was positive and supportive of the Central Bank setting out its thinking on the key considerations when developing and operationalising a macroprudential framework for the funds sector.

The general direction of DP11 was broadly supported, including the necessity to understand the collective action of fund cohorts in generating systemic risk, and the need to identify and address key vulnerabilities (liquidity mismatch and leverage), while also understanding interconnectedness in the sector. There were also some views shared on the limited evidence of liquidity mismatch within some fund cohorts.

The need for international coordination and the challenges inherent in achieving this, including the lack of a reciprocation framework, were highlighted as being of high importance. Examples included the risk that investors could shift risk to other jurisdictions or other parts of the wider financial system. The need to consider the heterogeneity of funds via the cohort-based approach outlined in DP11 was broadly welcomed, as opposed to a 'one-size-fits-all' viewpoint which would treat the entire funds sector as a whole. Other areas highlighted as being important to address in developing a wider framework included data sharing and addressing data gaps for the funds sector in general.

Also discussed at a high level were potential tools that could be used in developing a macroprudential framework. It was emphasised that tools must not be pro-cyclical in nature; they should be usable, while acknowledging that the calibration of such countercyclical tools may be complicated. Tools to limit or reduce the impact the interconnectedness would need further deliberation, alongside tailoring of tools to potential vulnerabilities within a fund cohort.

Key themes from Central Bank conference on macroprudential policy for investment funds

On 20 May 2024, the Central Bank hosted an international conference on Macroprudential Policy for Investment Funds. The conference built on the themes explored in DP11, and aimed to further the discussion on an overarching macroprudential framework for funds by bringing together expert views from the wide range of stakeholders that attended the conference. These included policymakers from central banks, securities regulators, academics, public decision-making bodies as well as industry representatives. The agenda for the conference included panel discussions on systemic risk, potential macroprudential tools for investment funds and the interaction between investor protection and financial stability (see Annex B for the full agenda).

On the need for a macroprudential framework, participants agreed that the importance of NBFIs – including funds – within the wider financial system had grown over recent years, and they now play an increasingly important role in the provision of services to other parts of the financial system and the broader economy. As such, there is a need to build the architecture for a resilient NBFI sector, so that, when shocks hit, it can withstand these rather than amplify and transmit them to the rest of the financial system and real economy.

During the discussions, differences in views were expressed on the need for a macroprudential framework for the funds sector. Some stakeholders noted that they do not see the need for a macroprudential framework, while others agreed it is important to strengthen resilience of funds *ex ante*, rather than waiting to take action at the onset of a crisis. Panellists agreed on the importance of such a framework being developed internationally, with some recent policy measures, including the LDI macroprudential measures in Ireland and Luxembourg, being cited as good examples of cross-border collaboration in this regard.

However, participants noted that any design of a macroprudential framework would be much more difficult than that designed for the banking sector post-financial crisis, due to the highly heterogeneous nature of the NBFI sector. Indeed, there were differences in views on how a macroprudential framework could be developed and operationalised in the funds sector.

With respect to the risks to which investment funds are exposed, liquidity and leverage risks are relatively well known, but participants noted that it is more difficult to evaluate the potential systemic risks derived from the interconnectedness of the funds sector.

Robust data was seen as key to identifying and monitoring risks in the NBFI sector. Participants noted that where data is available, it would benefit from wider data-sharing initiatives, which would also go some way towards addressing data gaps. While recognising that mapping these data would be both difficult and potentially burdensome for market participants, it was generally acknowledged as an important necessity moving forward.

Another important area raised during the conference was stress testing. Stress testing of the funds sector was considered to be a valuable exercise, but it was noted that international/system-wide stress tests are required to accurately simulate crisis events across jurisdictions, due to the highly global nature of the sector. To this end, being able to trace risks through the system would allow policymakers to see how they can impact across different markets at different times, although it was acknowledged that it is not a straightforward task. Reverse stress testing may be a valuable tool in such exercises. It was noted that the focus of such stress tests should not be on particular fund sectors, but rather on identifying the risks that certain fund cohorts might bring, which can then in turn be addressed.

A number of participants also discussed the interaction between financial stability and investor protection goals. Many supported the Central Bank's view that investor protection and financial stability are complementary objectives. More broadly, there was a general recognition that while the potential costs of any policy intervention may be felt immediately, benefits may not be as apparent, in the short term at least.

Some participants noted that the regulatory framework already incorporates a financial stability view, with UCITS and AIFs having leverage limits (or the ability to impose them on a discretionary basis), while funds are required to report their liquidity mismatches as part of the authorisation processes in many jurisdictions. Beyond this, it was noted by many participants that there are other tools already in place which can potentially be repurposed to also help mitigate system-wide risks, including redemption gates, anti-dilution levies and swing pricing. Policymakers noted that further work is underway in this regard, and ensuring consistency in both the availability and use of these tools is important going forward. This will require considerable and sustained international coordination.

Annexes

Annex A: Written responses received to Discussion Paper 11

1. The Association of Real Estate Funds (AREF)
2. Association française des investisseurs institutionnels (Af2i)
3. Blackrock
4. Commercial Real Estate Finance Council Europe (CREFC Europe)
5. The Investment Association (IA)
6. Investment Company Institute Global (ICI Global)
7. European Association for Investors in Non-Listed Real Estate (INREV)
8. Irish Funds
9. Alternative Investment Management Association
10. Trade Winds
11. State Street Global Advisors
12. Managed Funds Association
13. Public submissions x 3

Annex B: May 2024 Conference Agenda

Conference on Macroprudential Policy for Investment Funds

20th May 2024
Central Bank of Ireland

09:15 - 09:55	Registration & Refreshments
10:00 – 10:30	**Welcome Address** Gabriel Makhlouf, *Governor, Central Bank of Ireland*
10:30 – 11:00	**Keynote Speech** Verena Ross, *Chair, European Securities and Markets Authority (ESMA)*
11:00 – 11:15	Coffee Break
11:15 – 12:30	**Panel 1: Systemic Risk and the Need for a Macroprudential Framework for Investment Funds** Chair: Vasileios Madouros, *Deputy Governor, Monetary and Financial Stability, Central Bank of Ireland* Panel: Anil Kashyap, *Professor of Economics and Finance at the University of Chicago's Booth School of Business* Joanna Cound, *Head of Global Public Policy Group, BlackRock* Sarah Breeden, *Deputy Governor, Financial Stability, Bank of England* Nellie Liang, *Under Secretary of the Treasury for Domestic Finance, United States of America*

12:30 – 13:30	Lunch
13:30 – 14.45	**Panel 2: Potential Macroprudential Tools for Investment Funds and Operationalising a Macroprudential Framework**

Chair: Sharon Donnery, *Deputy Governor, Financial Regulation, Central Bank of Ireland*

Panel: Christina Choi, *Executive Director (Investment Products), Securities and Futures Commission, Hong Kong and Chair of the International Organization of Securities Commissions (IOSCO) Investment Management Committee*

Federico Cupelli, *Deputy Director, Regulatory Policy, European Fund and Asset Management Association*

Richard Portes, *Professor of Economics, London Business School and Co-Chair of the ESRB ATC-ASC Joint Expert Group on Non-Bank Financial Intermediation*

Francesco Mazzaferro, *Head of Secretariat, European Systemic Risk Board (ESRB)*

14:45 – 15.15	Coffee Break
15:15 – 15.45	**Keynote Speech**

Klaas Knot, *President, De Nederlandsche Bank and Chair of the Financial Stability Board (FSB)*

15:45 – 17.00	**Panel 3: Enhancing Funds Resilience with Macroprudential Action: Where Investor Protection meets Financial Stability**

Chair: Derville Rowland, *Deputy Governor, Consumer and Investor Protection, Central Bank of Ireland*

Panel: Kris Nathanail, *Chief of Staff, International Organization of Securities Commissions (IOSCO)*

Colm McDonagh, *Chair, Irish Funds and CEO, Insight Investment Management Europe*

Francois Haas, *Deputy Director, General Financial Stability and Operations, Banque de France*

Michael J. McGrath, *Assistant Secretary General, Financial Services Division, Department of Finance, Ireland*

17:00 – 17.15	**Closing Remarks**

Vasileios Madouros, *Deputy Governor, Monetary and Financial Stability, Central Bank of Ireland*