Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Discussion Paper
An approach to macroprudential policy for investment funds

Feedback from Investment Company Institute Global (ICI Global)

July 2024

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

ICI Global, which carries out the international work of the Investment Company Institute (ICI), shares the Central Bank of Ireland's (CBI) goal of ensuring a strong and resilient financial system. ICI is the leading association representing regulated investment funds, such as UCITS, mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs), with total assets of $37.3 trillion. Our mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. A hallmark of ICI is its devotion of substantial resources to conducting research on the regulated fund sector, including examination of the resilience of regulated funds and to address concerns expressed by policymakers about potential systemic risk.

We welcome the CBI's effort to advance the debate on bolstering the resilience of the global financial system. However, we believe that the CBI is not focusing on what we see as a major risk to financial stability - the outdated market structure for the transmission of liquidity through the financial system. As recent episodes of market stress have demonstrated, traditional private sector intermediaries of liquidity are unable, or unwilling, to provide enough liquidity to meet demand in a crisis.

While it is understandable that the CBI wants to examine product structures, including UCITS, we believe that the CBI and other regulators should be much more focused on liquidity supply. Central banks and securities regulators should address this problem urgently, rather than focusing disproportionately on product structures such as UCITS.

Investment funds play an important role in channelling investor savings into capital markets. We provide comments specifically regarding the regulated funds industry. We focus our comments on long-term regulated funds, rather than money market funds, whose regulatory frameworks have been modified significantly in the last 15 years, including new changes adopted in the US in July 2023.

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We would challenge the CBI's discussion of potential channels for systemic risk in regulated funds. In Section 2.1 of the Discussion Paper (DP), the CBI cites "coordination problems" that it says can result in a "first mover advantage" and lead to "run-like dynamics."

ICI has demonstrated through a substantial body of empirical analysis that the structure of mutual funds and UCITS does not prompt a first-mover advantage. As the paper on "Strategic Complementarity" by Christof Stahel demonstrates, the propensity to sell assets is statistically identical regardless of whether those assets are held directly by investors or if they are held indirectly through funds. An actionable first-mover advantage is premised on the existence of material dilution. ICI has analysed dilution in US mutual funds and UCITS fixed-income bond funds. We estimate that dilution is on average too small to incentivise the vast redemptions that are hypothesised to trigger or amplify financial stability risk.

Context is also critical to understand the potential impact of dilution on investor behaviour. In periods of market stress, such as March 2020, we find that estimated dilution increases, but is vastly outweighed by the daily variability in market returns. For example, the market value of high-yield bond UCITS fell 1,360 basis points in March 2020, whereas the average dilution for the entire month of March 2020 was between 3 and 28 basis points, depending on the method used to estimate dilution. Compared with changes in overall market conditions, these levels of estimated dilution would have been mere "background noise" for fund shareholders" investment decisions during March 2020.

A second channel of potential systemic risk identified by the CBI is "informational frictions" whereby investors in a mutualised vehicle overestimate the availability of liquidity in a fund. The CBI suggests that because of this "liquidity illusion", in times of stress "investors might seek redemptions from these funds to minimise negative returns, greater than what they might have done had they been holding these assets directly." If this were true, we would expect regulated fund shareholders react much more strongly during market downturns than direct investors in stocks and bonds. ICI's analysis of the US market indicates, however, that investors in mutual funds (indirect investors) and those in separately managed accounts (SMAs) (direct investors), react similarly to changes in

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market conditions. Thus, the regulated fund structure does not seem to cause fund shareholders to react differently than direct investors, suggesting that it is market conditions rather than the fund structure itself that is affecting investor behaviours.

The third channel cited by the CBI is "incentive frictions", such as moral hazard that can occur if market participants anticipate official support will be forthcoming in a stressed market. We have not seen evidence that moral hazard is unique to regulated funds. In cases like March 2020, central banks provided support to highly stressed financial markets, but this support was widespread across market participants, including nearly $500 billion in foreign exchange swaps that the Federal Reserve provided to non-US central banks.

In Section 2.2, the CBI identifies liquidity mismatch as an important issue. This is already being addressed by IOSCO and the FSB, and major jurisdictions have regulatory frameworks that require attention to liquidity management. For example, the EU recently revised its framework for UCITS and AIFS, and we have supported the wider availability of liquidity management tools.

With this important context, we believe that macroprudential policies such as those advanced by the CBI are ill-suited and unnecessary for the regulated funds industry.

The fundamental underlying premise of capital markets is that a diverse range of participants - including fund managers, individual investors, and institutions - make their own calculations about investment opportunities and the risk they are willing to bear. A macroprudential framework for regulated funds would hinder, rather than advance, the goal of developing well-functioning capital markets - one that exists alongside and complements the banking sector for the financing of the economy.

The risks that the DP attempts to address appear to primarily be market risks, which would manifest regardless of whether investors are investing through pooled vehicles or investing directly.

The DP identifies high leverage as another investment fund driver of systemic risk but relies on examples that do not involve regulated funds to make this point. The liability-driven investment (LDI) strategies and Long-Term Capital Management (LTCM) examples cited in Box A of the DP reference funds using leverage strategies

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that regulated funds could not employ. Although leverage in the financial system may be an important and necessary area for examination, the "high leverage" concerns reflected in the DP do not apply to regulated funds. In the EU, US, and other jurisdictions, regulated funds are subject to regulatory requirements, which limit their leverage.

These limits on leverage among regulated funds are borne out at the international level. As IOSCO observed in its reporting of leverage data in the asset management industry, open-ended funds "mainly have long exposures to cash securities assets, so it cannot be interpreted as anything close to leverage" that can be measured by any meaningful metric. Similarly, closed-ended funds "exhibit little to no leverage." IOSCO, Investment Funds Statistics Report (Jan 2023) at 3-5, 27, 37, 41, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD645.pdf.

ICI Global would welcome additional policy work on modernising the market structure for liquidity supply to enhance the functioning and resilience of capital markets and would encourage the CBI to consider adding this issue as one of its key objectives.

As an additional key objective, we would encourage the CBI to remain focused on ensuring that any measures it considers support fairness among investors. Regulated funds have provided significant benefits to individual investors for decades. It will be important that policy measures do not inadvertently create penalties for investors based simply on the choice of investment vehicle.

Finally, we urge the CBI to recognise distinctions across the sector and not apply a one-size-fits-all assessment of risk. For example, in some cases, the DP extrapolates from the experience of one type of fund a presumption that a similar risk is present across all types of funds, which, as we note above, is not the case.

For more detail about ICI's research on these matters, please see Appendix A of ICI Global Comment Letter to FSB on Proposed Revisions to the FSB's 2017 Policy Recommendations, available at https://www.ici.org/system/files/2023-09/23-cl-icig-fsb-oef-policies.pdf.

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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?

We find little evidence of collective actions among regulated funds generating systemic risks. To take the example of March 2020, many types of market participants were net sellers of a wide range of assets. However, the DP does not address this broad-based market selloff, but rather, cites "collective actions of funds" as a source of systemic risk and in Box A points to March 2020 to say "a shock or trigger event was amplified by the collective behaviour of fund cohorts...." ICI research is contrary to the CBI's narrative around March 2020. We show that activities of US bond mutual funds had little to no impact on the US Treasury and corporate bond markets during March 2020 despite aggregate outflows that were much larger than normal - consistent with broad-based market selling. For example, in March 2020, liquidity strains in Treasuries began several days before US bond mutual funds began selling appreciable quantities of US Treasury debt. Moreover, even when US bond mutual funds' net sales of Treasuries were at their heaviest, they amounted to only 5 percent of US Treasury trading volume. A full description of this research is available at https://www.ici.org/viewpoints/22-view-bondfund-survey-3. Further, the largest sellers of US Treasury securities were foreign official entities, including central banks. We would encourage policy officials, including the CBI, to examine why central banks sold Treasuries in such large quantities and what the impact of this heavy central bank selling was on the broader financial markets.

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Other ICI research shows that US bond mutual funds sold a relatively small amount of investment-grade ($10 billion) and high-yield corporate bonds ($11 billion) during the March 2020 crisis. Furthermore, these net sales had a negligible impact on credit spreads - accounting for only an estimated 5 basis points of the 313-basis point increase in the investment-grade corporate bond spread and only 19 basis points of the 557-basis point increase in the high-yield corporate bond spread, (See, Letter from Eric J. Pan to Vanessa Countryman, Re: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting (File No. S7-26-22) (Feb. 14, 2023), at Appendix A pp 31-38 and 63-67, available https://www.ici.org/system/files/2023-02/23-cl-sec-liquidity-proposal.pdf. These findings challenge the presumption that collective actions of regulated funds amplify financial stability risk.

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?

No, we do not agree with the CBI's premise. The existing legal and regulatory frameworks for regulated funds, with primary statutes enacted in the US in the 1930s and 1940 and for the EU beginning in 1985, are robust, well established and fit for purpose. There also are capital markets and fund regulators overseeing regulated funds. Critical features of frameworks for regulated funds include, among others, requirements for: limits on leverage and borrowing (as discussed in Question 1); liquidity risk management; conflicts; extensive disclosures (including with regard to risk and investments); custody; mark-to-market valuation of assets and NAV calculation; and investment restrictions or limitations (e.g., "eligible assets", concentration and/or diversification).

It is important to note as well that the structural features of regulated funds help limit risk and its transmission. Typically, each regulated fund is a separate legal entity with its own shareholders, and the assets of each regulated fund are separate and distinct from, and not available to claims by creditors of, other funds or the fund

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manager. Each regulated fund has its own investment objectives, strategies, and policies. Regulated funds' economic exposures vary, and the losses of a regulated fund belong to that fund and its investors. While regulated funds interact with other market participants, the counterparty interactions are limited and subject to the regulatory constraints and protections noted above, including any regulations governing a counterparty and its activities.

As explained in response to Question 1, we believe there is no compelling evidence that the regulated fund structure creates unique risks to financial stability or serves to generate or amplify shocks. Similarly, we find that investors who invest in funds and those who invest directly in markets exhibit substantially similar behaviour in response to changes in market conditions.

As a result, it appears that many of the concerns outlined in the DP relate to broader market risks, rather than risks specific to the regulated funds sector. By extension, we urge that any new policies that the CBI may consider implementing focus on the broader market, rather than narrowly on regulated funds.

Finally, in its discussion of the existing regulatory framework, the DP expresses concerns that in some cases fund managers are exercising permitted flexibilities in their approaches on issues such as liquidity management. Such flexibility does not inherently limit the effectiveness of current regimes. Rather, given the wide diversity among regulated funds, flexibility is a necessity. Fund managers must have the ability to prudently and effectively manage risks associated with each specific fund, in the best interest of that fund and its shareholders. For example, by any measure, and for decades, US regulated funds have managed liquidity and met redemptions successfully. For instance, in 2022, long-term mutual funds successfully navigated gross redemptions totalling $5.6 trillion, or 25 percent of year-end 2021 assets for those funds. Cases of US regulated funds failing to meet redemptions are exceedingly rare (e.g., we have identified only 12 instances in over 80 years where the US Securities and Exchange Commission (SEC) granted exemptive orders permitting funds to suspend redemptions (excluding emergency situations outside the control of a fund's adviser). As highlighted in the DP, in the specific case of money-market funds, it is the lack of flexibility through policies such as fixed minimum liquidity

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requirements, which during stressed conditions has at times led to unwanted cliff effects and reduced availability of liquidity. Notably, the SEC recently amended certain interconnected fee and gate and liquidity threshold provisions in its rule governing US money market funds after concluding that they exacerbated the redemption pressures experienced by some funds during March 2020.

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?

ICI Global and its members share the CBI's overall goal of ensuring a strong and resilient financial system. However, macroprudential policies as envisioned by the CBI are ill-suited for the regulated funds industry. Macroprudential policy is based on bank-centric concepts and approaches that are not appropriate for the regulated funds sector.

As stated above, the fundamental underlying premise of capital markets is that a diverse range of participants - including fund managers, individual investors, and institutions - make their own calculations about investment opportunities and the risk they are willing to bear. A macroprudential framework would hinder, rather than advance, the EU's goal of developing a well-functioning and integrated Capital Markets Union - one that exists alongside and complements the banking sector for the financing of the economy.

Moreover, as described in our responses to the previous questions, little evidence exists that regulated funds represent a unique risk to financial stability or to the generation or amplification of shocks. Rather, the risks that the DP attempts to address appear to primarily be market risks, which would manifest regardless of whether investors are investing through pooled vehicles or investing directly.

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ICI Global would welcome additional policy focus on modernising market structure around the supply of liquidity. We have seen multiple examples, particularly following the banking sector reforms in the wake of the Global Financial Crisis, in which the supply of liquidity has become highly constrained during periods of stress. In our view, greater attention should be paid to addressing such supply constraints, rather than continuing to focus primarily on the demand for liquidity, which comes not only from regulated funds but also from other investors and market participants. Such market-wide enhancements would not only support funds' ability to manage liquidity risk, but would also foster greater resilience across the capital market.

Finally, as an additional key objective, we would encourage the CBI to remain focused on ensuring that any measures it considers taking continue to support the interests of fund investors generally. Regulated funds have provided significant benefits to individual investors for decades. Policy measures must not inadvertently create penalties for investors based simply on the choice of investment vehicle.

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?

As described in other responses, macroprudential tools are generally not suitable for regulated funds. The design of tools envisioned in the DP are short on detail, making it hard to assess each one. However, we are supportive of making available a wide range of liquidity management tools for open-ended funds and money market funds to use at their discretion, as we describe in the following recent publications:

- ICI, Letter from Michael N. Pedroni to John Schindler, Re: Proposed Revisions to the FSB's 2017 Policy Recommendations (Sept 2023), available at https://www.ici.org/system/files/2023-09/23-cl-icig-fsb-oef-policies.pdf

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- ICI, Letter from Michael N. Pedroni to Damien Shanahan, Re: Public Comment on Liquidity Management Tool Guidance - Consultation Report (Sept 2023), available at https://www.ici.org/system/files/2023-09/23-cl-icig-iosco-lmt-guidance.pdf
- ICI, Letter from Eric J. Pan to FSB, Re: Consultation Report on Policy Proposals to Enhance Money Market Fund Resilience (Aug 2021), available at https://www.ici.org/system/files/2021-08/21ltrfsbmmfs.pdf

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

As explained in the response to Question 2, little evidence exists that the collective actions among regulated funds or their interconnectedness uniquely generate systemic risks. Further, as explained in response to Question 1, we find no evidence that the regulated fund structure creates unique risks to financial stability or serves to generate or amplify shocks. Accordingly, we do not agree that there is a need for macroprudential tools to address the interconnectedness of regulated funds as well as, or instead of, potential vulnerabilities.

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

Since we believe that macroprudential tools are generally not suitable for regulated funds, we do not express a view on governance and data considerations relating to operationalisation of a macroprudential policy for funds.

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

None at this time.

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