Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Discussion Paper
An approach to macroprudential policy for investment funds

Feedback from the Managed Funds Association (MFA)

July 2024

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

It is important to consider the different types of investment funds that may generate systemic risk, recognizing that not all investment funds create the same risks. An analysis of liquidity risk management and the use of leverage in the private funds industry necessarily is a fund-by-fund analysis.

A. Private Funds Manage Liquidity Risk Through Contractual Limitations

Private funds do not offer daily redemption to investors, and as such have not been susceptible to mass redemptions in times of stress. Private fund documents govern investor liquidity standards for investors.

Private funds' investors are typically large, sophisticated institutional investors such as foundations, endowments, and pension funds - and they understand the redemption limitations on the fund and often times have multi-generational investment horizons. We did not see mass redemptions from private funds during times of stress, largely because the fund sophisticated private fund investors knew and appreciated the redemption limitations to which they agreed, and the private funds enforced fairly the redemption terms agreed to by investors.

The liquidity risk of a given private fund is correlated to the liquidity of the underlying assets. A typical hedge fund, which is invested in a portfolio of liquid securities and other investments, may offer redemptions quarterly, up to a stated percentage of the fund's assets. Once that stated percentage is met, no additional redemptions are permitted for that period. Managing redemption amounts by contract has proven an effective means for private funds to manage liquidity risk. Further, private fund investors agree to, and have the sophistication to, appreciate the limitations on redemptions required of the fund.

Back to "Contents"

The less-liquid the portfolio holdings, the longer the contractual limits on redemptions tend to be. Private credit funds, for example, tend to have multi-year lock-up periods to reflect the less-liquid nature of the underlying investments. Private credit funds typically hold direct loans, for example, through maturity as there is no developed secondary market for these bespoke, individually negotiated loans. Frequent redemptions simply would not work in a private credit fund as they may with a private fund investing in large-cap, liquid equity securities.

B. The Use of Leverage by Private Funds Is Effectively Risk-Managed by Both the Fund and Its Counterparties

As noted above, counterparties to private funds manage their own risks and limit contagion risk through margin and collateral requirements. These requirements also create an economic disincentive for the investor to incur excessive risk. For funds that use leverage, it moreover is important to not conflate a fund's use of leverage across the financial system as a whole, or even with risk levels proposed by an organisation that manages a fund that uses leverage. Because asset classes each have distinct risk exposures, leverage metrics based on a single aggregate number across asset classes do not provide a meaningful basis on which to assess the risks associated with an investment funds use of leverage and are likely to mislead regulatory authorities reviewing the data. The review of misleading data could result in regulatory authorities attempting to solve a non-existent problem, leading it to potentially miss areas of systemic risk that exist in the financial ecosystem in areas other than investment funds. Leverage measurements must be assessed on an asset class by asset class basis, rather than as a single aggregated number. It furthermore is critical that regulatory authorities consider the purpose of leverage: a bona fide hedging transaction mitigates risk (both the fund and systemically), whereas a speculative naked call option does not.

Back to “Contents”

Across the fund industry globally, private funds are relatively limited users of leverage. The US Federal Reserve for example stated with respect to private credit that "most private credit funds use little leverage and have low redemption risks, making it unlikely that these funds would amplify market stress through asset sales." Private funds are more commonly holders of long positions in debt and equity investments that are acquired through capital invested by investors, and leveraged positions are often times derivative positions to hedge against currency or interest rate risks. It therefore is far more common that the investors are bearers of counterparty exposure risk rather than transmitters of risk to the counterparties.

It should be noted that many institutional investors beyond investment funds use leverage in some form and it would be unfair to single out investment funds as the target of any macroprudential regulation in this regard.

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?

Systemic risk results from more complicated factors than a simple collective action problem. In the private funds sector, there exist a multitude of strategies that often are not correlated with each other and in fact, the diverse strategies serve to mitigate or diffuse collective risks because the strategies have different underlying risk profiles, assets, and liquidity constraints. Collective action risk exists in the global markets across the investment spectrum and cannot be fairly targeted to private funds, or investment funds more generally -- investors of all sizes trade securities in parallel based on news or economic events and it would be inappropriate to solely target investment funds in this regard.

Back to "Contents"

Market forces also can dampen the impact of collective action across the broader market place. As an example, short interest in individual names is published by dealers regularly, and it is true that investors, whether they are private funds or investment managers of separately managed accounts, may engage in "copycat" trading strategies and short the same positions. Here, the markets effectively self-correct: as short interest grows, the rate charged to borrow the securities to effect the short sale increases, reflecting the finite quantity of securities available to cover and creating an economic disincentive for excessive shorting of the same name.

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?

The current regulatory framework already addresses systemic risks for investment fund activities. The investor protection focus of the existing regulatory framework, including the UCITS Directive, is appropriate for funds with retail investors. The UCITS Directive contains provisions to ensure ongoing liquidity and limit fund holdings in illiquid assets for funds with daily liquidity requirements. Leverage limitations for investment funds are addressed both by the UCITS directive and AIFMD. AIFMD obligates private fund managers to report leverage and grants authority to impose limits on leverage under Article 25. Because existing regulatory requirements govern managers' uses of liquidity and leverage, additional regulations aimed at macroprudential issues for private funds would appear redundant to existing applicable regulatory requirements.

Macroprudential regulation, attempting to manage or mitigate risks, for private funds, is misplaced. The investment risks of private funds are shouldered by the sophisticated institutional investors of the funds. The activities of private funds are already subject to extensive systemic-related regulations; private funds' activities also are exceedingly unlikely to create stability risks for Irish or EU financial systems. In the US, as it relates to private credit funds for example, the Federal Reserve has stated that "financial stability vulnerabilities

Back to "Contents"

posed by private credit funds appear to be limited." We agree, as the activities of private funds are best suited to market and investor protection regulation by functional regulators, rather than bank-like supervision and regulation. Private funds historically have provided resilience to financial markets in the EU and US, often during stressed market conditions.

Critically, private funds differ from other financial market participants because they are ultimately vehicles for the management of others' assets. Private funds therefore do not maintain a large balance sheet of their own assets. Private funds facilitate access to particular financial instruments or strategies on behalf of sophisticated investors that understand the liquidity limitations of the fund and are capable of assessing and bearing investment risks. In the US, the Dodd-Frank Act already acknowledges this reality, which requires the US stability regulators in exercising its authority to consider "the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse."

MFA is committed to collaborating with the primary financial regulators of private funds and their advisers to mitigate emerging risks to U.S. financial stability. Existing regulations currently require robust liquidity risk management practices and liquidity limits, and allow regulators to monitor for leverage. MFA recommends that the Central Bank work alongside other market regulators to craft activity-specific recommendations to be applied to all market participants (not just investment funds) to the extent the data demonstrate the existence of a systemic risk suitable for a regulatory solution.

Back to "Contents"

A. Private Funds Provide Resiliency to Financial Markets and Are Subject to Extensive Reporting Requirements

The risk management practices of private funds, prevailing market structure, and the existing regulatory framework all significantly limit the potential that private funds would act as a source of systemic risk. The private fund industry is characterized by low concentration, low contagion risk, and robust risk management practices. These characteristics alongside existing regulatory structures make private funds better suited to activities-based oversight.

The private fund industry is further characterized by diversity which has enhanced resiliency for financial stability. While global banking is intensely concentrated among the largest firms, private funds demonstrate much greater competitiveness. This diversity means that Central Bank concerns, such as interconnectedness and concentration, are of diminished relevance when applied to the private fund industry.

Considering the aforementioned characteristics of the private fund industry, MFA recommends that the Central Bank continue to focus on systemic risk monitoring activities. Private funds currently report extensive information to the European Systemic Risk Board ("ESRB") on Annex IV under AIFMD. In the US, private funds similarly report extensive risk metrics to the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), including stress tests, portfolio information including collateral, margin and cash reserves, counterparty exposures and myriad other details, all of which are available to FSOC. Given that the ESRB already collects systemic data for EU AIFMs and non-EU AIFMs marketing in the EU, the ESRB should lead any effort to expand the data AIFMs report on Annex IV. MFA encourages the Central Bank to continue its interagency coordination with US and other regulators as it relates to regulatory reporting of private fund data for systemic risk and related purposes. We recommend that the Central Bank continue to focus on these efforts and increase

Back to "Contents"

its dialogue with market participants and other stakeholders to foster efficient, transparent, fair, and effective policy.

B. Bank-Like Regulation of Private Funds Would Not Enhance Financial Stability

Private funds, regardless of strategy, are fundamentally different from banks. Private funds are not funded by liabilities like deposits, which are redeemable at par and on demand, and do not benefit from deposit insurance or typical government-sponsored liquidity. Instead, private fund investors commit long-term capital, take investment risk, and accordingly agree to redemption limits established and enforced by fund managers to manage liquidity. Private funds fundamentally are investment products limited to sophisticated parties that do not require daily or "on demand" liquidity, are typically advised by professionals, and understand the investment and related risks. Private funds should be regulated accordingly and are so regulated by applicable functional regulators in the US and EU.

The Central Bank's evaluations of activities-based regulation or other action must consider costs and benefits to the affected investment fund(s). On this score, MFA remains deeply skeptical of suggestions to impose bank-like regulation onto a private fund. Risk management is a cornerstone of the private fund industry, and firms have taken steps to mitigate identified risks. For example, as evidenced in the quarterly Form PF reports filed with the SEC, financing for private funds is overwhelmingly obtained through collateralised arrangements from sophisticated counterparties with robust risk monitoring. In the US, considering the US private funds market, the US Government Accountability Office concluded that leverage lending had not contributed to bank (or other financial entity) distress, which suggests that banks are effectively managing exposure leverages to borrowers through collateral and other margin requirements, thus serving to mitigate any interconnectedness risk (i.e., risk of contagion). The GAO study is relevant to the Discussion Paper

Back to "Contents"

as many private funds organised in Ireland trade through US-based banks.

Private funds also manage liquidity risk by contractually controlling the timing and amount of redemptions given the investment strategy of the fund. Being able to control redemptions greatly mitigates fire sale concerns. Form PF in the US reports provide detailed analyses of asset and liability liquidity, including redemption provisions.

While any determinative conclusions would require formal cost-benefit analysis on an entity-by-entity basis, the costs imposed by the capital requirements, supervision and resolution planning requirements that result from bank-like regulation would be significant and potentially fatal to the private fund, and wholly unnecessary and/or redundant to existing requirements. Elimination of private funds reduces the availability of capital for businesses and would adversely affect innovation and increase financing costs, reducing the resiliency of both the financial markets and the real economy. For investors such as pension funds, foundations, endowments, and insurance companies, a reduced market for private funds associated with markedly higher compliance costs would remove a critical source of uncorrelated returns and harm these institutional investors and their beneficiaries.

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 key principle for investment fund regulators globally is access to reliable data from the investment funds to assess the level of liquidity and risk more accurately in the system. MFA appreciates the efforts of the Central Bank to expand the development of its portal ("Portal") to investment funds. Currently, investment funds submit financial statements, a fund profile, reports of derivatives usage, and material breaches or other material matters through the Portal.

Back to "Contents"

Despite the use of the Central Bank's Portal by investment funds to report information, the Discussion Paper notes that data is a "key challenge" to "facilitate[] risk identification, policy design, and evaluation." MFA agrees and supports the Central Bank's recognition of an internationally consistent data framework — it should be an essential pre-requisite for any consideration of the exercise of macroprudential authority.

MFA encourages the Form PF and Annex IV reporting requirements to be harmonized where possible, and urges the Central Bank to advocate harmonized requirements to the ESRB. Inconsistent data sets in the Form PF and Annex IV data (such as derivatives trade reporting, as an example) severely limits the usefulness of the data itself. Without accurate data from private funds that is comparable across jurisdictions, it is difficult for regulatory authorities to obtain a clear picture of investment funds and their strategies, investments, size, and risks. Accurate, reliable data must serve as the predicate for any justification of the need for macroprudential regulation by the Central Bank or any other regulatory body to address activities or products that may present systemic risks.

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?

When it comes to the design of macroprudential tools, if the goal is to reduce systemic risk, a healthy first step would be to understand what risks are presented. As we have discussed, there is nothing unique about either private funds' structures or investment strategies that are harbingers of systemic risks. Without adequate data, however, it is difficult for any regulatory authority to assess risk, much less regulate and mitigate any such risk.

In addition, MFA suggests that if the Central Bank identifies information filed by a particular investment fund that would suggest the existence of systemic risk posed by that fund, it should engage with the investment fund directly and collaboratively to better understand the nature of the risk. If the Central Bank identifies

Back to "Contents"

collective characteristics of funds that pose systemic risks, then the Central Bank should engage with the SEC and other global regulatory authorities to take an activity-based approach, coordinated globally, to address the systemic risk(s) that fund data demonstrate are present. A "regulation by hypothesis" approach simply is not appropriate.

We do not agree that additional systemic tools should be explored. As we have seen in the US, designation of non-bank entities as systemically important, and thereby attempting to apply banking regulation to non-bank entities has been ineffective. Initial efforts by the FSOC to designate entities as systemically important have been nullified by courts for failing to adequately consider the costs and benefits of such designation to the affected entity.

Further, as noted above, the tools used by systemic regulators are ill-suited and redundant to existing regulatory requirements. US non-bank entities that have been deemed systemically important, before the FSOC guidance was revised in 2019, have been required to perform stress tests and maintain resolution plans to discuss how a failing non-bank entity would wind-down its operations in an orderly manner.

On stress testing, we note that private funds in the US are currently required by Form PF to perform stress tests regularly and report the results of those tests to the SEC and FSOC. It is not necessary for the Central Bank to impose a duplicative stress test requirement. Resolution plans, as we discuss below in response to Question 6, are not applicable to private funds: private funds fail from time to time, for a variety of reasons. When they do, there is an orderly process that begins with the prime brokers and other counterparties declaring an event of default and closing out positions according to the underlying agreements. The fund assets are then liquidated, with the cash and securities proceeds distributed to the sophisticated investors on a pro-rata basis. There simply is no need to prepare a resolution plan that lays out this orderly, routine process.

Back to "Contents"

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

Investment funds, by their nature, require some degree of interconnectedness. They rely on executing dealers to buy and sell securities and financial products on their behalf. Investment funds rely on custodians to safe keep investment assets, and fund administrators to perform account on-boarding and related functions.

Private Fund Interconnectedness Does Not Result in Systemic Risk for Which Macroprudential Regulation Is Necessary or Appropriate

Private funds have been shown to pose modest, at best, interconnectedness risk partly because of the limited use of leverage and strong risk management controls. Margin and collateral requirements serve to limit the amount of leverage that a private fund can incur, and dealers can increase or adjust requirements to manage leverage and other risks as trading, credit, or market conditions warrant.

The Discussion Paper states that macroprudential tools could target vulnerabilities such as a liquidity mismatch and leverage of fund cohorts. With this standard of "interconnectedness", the key issue would appear to be not only whether an investment fund is "connected" to other market participants but whether the entity's failure could force a disorderly unwinding of positions (both on- and off-balance sheet) that would result in a cascading series of failures among counterparties that could spread elsewhere within the counterparty firm or to the counterparties of that counterparty.

As a general matter, relationships with counterparties are an appropriate area of focus when considering the potential for transmission of risk throughout the system. Adequate risk management by both the private fund and the counterparty can and does mitigate the possibilities of losses resulting from

Back to "Contents"

risk transmission. The risk-mitigation reforms enacted globally after the GFC have done much to reduce transmission of risk throughout the system, with an emphasis on clearing derivatives transactions, prompt reporting of them to regulators, and requiring minimum margin amounts for uncleared transactions.

A. The Concept of "Too Big to Fail" Does Not Apply to Private Funds

All losses to a private fund that winds down its operations are borne by the sophisticated, institutional investors. There is no taxpayer "bailout" or concept of "too big to fail". Private funds have and will continue to close and, each time, there is no systemic risk because the fund structure silos the losses, which are borne by the private fund investors.

Relatedly, each year there are private funds that wind down and they do not cause financial stability problems when doing so. No private fund closure during the 2008 financial crisis or since has threatened market functioning or financial stability. Regulations implemented because of the European Market Infrastructure Regulation ("EMIR") and the Dodd-Frank Act, including derivatives clearing, margining, and reporting, have further bolstered the resiliency of the private fund industry and minimize the risk a private fund failure would spread to its counterparties or more broadly. Counterparty risk management practices also have strengthened considerably, further reducing the likelihood that counterparty exposures, even in periods of market stress, would have widespread impact on financial markets.

Any suggestion that the interconnectedness of private funds can amplify the effects of a shock to the financial system is, respectfully, misplaced and does not reflect the experience of private funds that actually have failed and the absence of any interconnectedness risk associated with the winding down of those funds. Private funds fail for a variety of reasons, whether from the failure to attract and maintain sufficient assets, mergers or reorganizations with other entities, or poor

Back to "Contents"

performance. Private funds unwind in an established and orderly process. Agreements such as prime brokerage agreements and trading agreements (such as ISDAs or master repurchase agreements) are terminated, closing positions are valued pursuant to those agreements, and the fund or the counterparty pay any difference owed. The fund then liquidates its assets and distributes the proceeds (either in cash and/or investments) to limited partners on a pro rata basis.

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

We discuss the need for accurate data reporting on AIFMDs in response to Items 3 and 4, above.

MFA concurs with the assessment of the Central Bank that the investment funds industry is global in nature. Irish-based funds offered in the EU may be available to investors in the US and elsewhere. As such, it is critical that regulators recognize substantially equivalent regulatory regimes in other jurisdictions to facilitate the global growth of the investment funds industry The global investment funds industry benefits with appropriate reciprocity amongst jurisdictions as “without this, there is risk of a fragmented macroprudential framework for investment funds which could limit effectiveness and unnecessarily increase costs for industry and, potentially its customers.”

The actions of one regulatory authority can in fact impact other jurisdictions. A fund that is operating globally may find itself having to comply with the most burdensome common requirement amongst jurisdictions or attempt to offer a fund only in that jurisdiction that would operate in parallel to other funds with the same strategy that are offered in other jurisdictions. Regulatory inconsistencies that drive private fund organizational structures can dilute or eliminate economies of scale the manager has sought to achieve. MFA agrees that some degree of flexibility will be needed to “account for different conditions and circumstances across jurisdictions”.

Back to “Contents”

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

MFA suggests that the Central Bank carefully consider the problem it is seeking to solve and whether any macroprudential policy for investment funds can appropriately be applied to private funds. Private funds manage liquidity risk by contract, based on the redemption limits investors agree to which, as discussed above, vary depending on the underlying strategy of the private fund. Leverage is risk-managed by both the private fund and its counterparties, consistent with applicable margin and collateral requirements.

To the extent there are activities of investment funds that the Central Bank, in consultation with other global regulators, deem to be systemically risky, MFA urges the Central Bank to consider working with functional regulators to develop and propose the necessary rules to limit the activity that it deems systemically risky. Designating an entity as systemically important would be misplaced and ultimately leave the macro-level systemic risk largely where it was: the designation would merely cause the target entity to seek to de-risk its activities by selling off business lines or ceasing activities, causing those systemic risks to be dispersed elsewhere in the financial ecosystem.

The markets have evolved considerably since the days of Long-Term Capital Management, and citing it as an example of spill over risk is out of place in today's financial system. Global regulatory reforms, combined with vastly improved risk management practices at dealers and investment funds alike, reduce considerably the likelihood of a repeat event caused by a single fund. Global regulatory reforms in the areas of derivatives clearing, reporting, uncleared swap margin requirements, and enhanced central counterparty resilience have strengthened our markets and buy-side and sell-side participants' risk management considerably. Any effort to develop any macroprudential regulation for the investment funds industry, private funds in particular, must be viewed through a current perspective that reflects the regulatory regime and market participants risk controls, rather than the failure of a single, highly leveraged fund 25 years ago - before EMIR, before Dodd-Frank, and before swaps regulation generally.

T: +353 (0)1 224 5800
E: publications@centralbank.ie
www.centralbank.ie

Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem