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July 31, 2023

Central Bank of Ireland Releases Discussion Paper on Marcroprudential Policy for Investment Funds

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TO: ICI Global Members
Asia Regulatory and Policy Committee
Europe Regulatory and Policy Committee
Financial Stability and OEF Working Group
Liquidity Rule Implementation Working Group SUBJECTS: Closed-End Funds
Exchange-Traded Funds (ETFs)
Financial Stability
International/Global
Money Market Funds
Risk Oversight RE: Central Bank of Ireland Releases Discussion Paper on Marcroprudential Policy for Investment Funds

On July 18, the Central Bank of Ireland (CBI) published a discussion paper entitled "An approach to macroprudential policy for investment funds" [[i]] (Discussion Paper). The CBI is accepting comments until November 15.

Background

The Discussion Paper is the latest entry in the ongoing international discussion regarding the potential systemic risk posed by the funds sector. Earlier in July, the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) published consultations regarding liquidity risk management in open-ended funds (OEFs)[[ii]]. The Discussion Paper expresses support for this work and borrows heavily from those proposals. It also leans on the ECB Financial Stability Review from May 2023[iii].

Objective

CBI seeks to address perceived systemic risk stemming from identified vulnerabilities in the funds sector - liquidity, leverage and interconnectedness. In the paper, CBI questions whether the existing regulatory framework is sufficient to address the risks the fund sector presents. The Discussion Paper notes that there is only one specifically designed macroprudential tool in EU funds legislation with limited applicability. CBI's proposed solution is to develop new macroprudential tools and re-design existing tools to mitigate these vulnerabilities. The Discussion Paper does not propose definitive tools. Rather, it provides the CBI's perspective on the issues and aims to generate feedback from stakeholders to help inform its participation in international or European regulatory discussions on the topic, as well as its policy and analytical work on investment fund issues more broadly.

Themes

In contrast to recent FSB and IOSCO work, which has published separate proposals and recommendations for different types of funds (i.e., ETFs, MMFs, OEFs), the Discussion Paper addresses the entire fund sector. While CBI acknowledges that different "cohorts" of funds present varied levels of risk, it nevertheless conflates the risks associated with different types of funds through vague and unclarified statements.[iv]

Similar to ongoing work at the FSB, CBI grounds the need for macroprudential framework in the significant growth in the global non-bank financial intermediation (NBFI) sector since 2008, much of which can be attributed to growth in the funds sector. CBI also looks for support in historical events including the liability driven investment (LDI) strategies in 2022, March 2020, the Global Financial Crisis, and the collapse of Long-Term Capital Management. Here too, the Discussion Paper extrapolates concerns from these events for the entire fund sector, where it may not be appropriate to do so.

Nevertheless, the Discussion Paper does acknowledge diversity in the fund sector and that there is no "one-size-fits-all" approach to liquidity risk management for funds. In addition, CBI recognizes that the fund sector cannot be considered in isolation from the broader economy and financial ecosystem.

Vulnerabilities and Tools

The Discussion Paper posits that, following a trigger or shock, the magnitude of the vulnerabilities and interconnectedness of the fund sector with the real economy can transmit and/or amplify systemic risk. The paper then ascribes three categories of vulnerabilities to the funds sector that can arise through economic frictions in intermediation and collective actions across the sector: liquidity mismatch, leverage, and interconnectedness. The Discussion Paper explores tools at a high level that could be used to address each of these vulnerabilities.

For liquidity, tools can narrow misalignment between liquidity of assets and redemption frequency by either reducing the liquidity of liabilities or increasing the liquidity of assets. The paper notes that such tools do not reduce the mismatch itself, but rather aim to limit the economic frictions it can generate. Price-based liquidity management tools (LMTs) and quantity-based LMTs could be used. In order to adapt them to macroprudential purposes, the Discussion Paper suggests that regulatory frameworks for price-based LMTs could become more prescriptive, longer notice periods could be required for less liquid funds, liquid asset buffers could be calibrated for fund cohorts, and there could be more granular stress testing requirements.

Leverage limits are highlighted as the key tool to address leverage vulnerabilities. However, significant operational challenges are identified associated with measuring leverage and leakage (circumventing limits through establishment of new entities). CBI expresses interest in exploring additional options but does not identify any.

CBI notes that measures aimed at reducing or mitigating interconnectedness are relatively less developed. Concentration limits and margining could be used to address interconnectedness directly, but it may also be possible to target interconnectedness through the tools aimed at liquidity and leverage.

Key Principles for a Macroprudential Framework

The Discussion Paper outlines a set of principles that should inform the design and operation for a macroprudential framework for the fund sector.

- Broad applicability to fund cohorts. Such an approach addresses the collective impact of correlated behavior across a cohort of funds, while also recognizing diversity across the funds sector.
- Build resilience ex ante. Ex ante tools need to be developed to reduce risk in the financial system prior to the onset of market stress.
- Target vulnerabilities and/or channels of contagion. Policies need to be targeted and proportionate, based on an assessment of the magnitude of systemic risk.
- Flexibility. Policies need to adapt to the changing nature and magnitude of risks over time.
- Balance benefits and costs. Impacts on the sector must be considered, including any cliff effects.
- International engagement and coordination. Since the funds sector is global in nature, coordination reduces the potential for regulatory arbitrage, spillovers, and leakages.

Key Challenges

CBI provides an overview of several challenges in developing a macroprudential framework for the funds sector. Governance and the potential for cross-border impacts must be considered in order to keep capital markets functioning effectively. Regulatory authorities should not replace funds risk management. High-quality data frameworks need to be operationalized, but to date, data sharing and consistency have particularly been raised as issues in FSB and IOSCO work.

Next Steps

CBI seeks stakeholder feedback by November 15, 2023 to inform its participation in international and European regulatory discussions, as well as to guide its policy and analytical work.

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Notes

[i] An approach to macroprudential policy for investment funds , July 18, 2023, available from
https://www.centralbank.ie/docs/default-source/publications/discussion-papers/discussion-paper-11/dp-11-an-approach-to-macroprudential-policy-for-investment-funds.pdf?sfvrsn=23059f1d_3

[ii] Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds - Revisions to the FSB's 2017 Policy Recommendations (FSB Consultation), July 5, 2023, available from https://www.fsb.org/wp-content/uploads/P050723.pdf ; Anti-dilution Liquidity Management Tools - Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes (IOSCO Consultation), July 5, 2023, available from https://www.iosco.org/library/pubdocs/pdf/IOSCOPD739.pdf

[iii] Financial Stability Review, ECB May 2023, available from https://www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202305~65f8cb74d7.en.pdf

[iv] For example, the Discussion Paper specifically associates structural liquidity mismatch in relation to the liquidity vulnerability of OEFs. Yet when describing the leverage vulnerability, the paper fails to acknowledge the specific types of funds that are subject to the risk (and those that are not).
