MEMO# 35517

November 28, 2023

ICI Responds to Central Bank of Ireland Discussion Paper on a Macroprudential Approach for Investment Funds

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TO: ICI Global Members
Europe Regulatory and Policy Committee
Financial Stability and OEF Working Group
Liquidity Rule Implementation Working Group
SEC Rules Committee SUBJECTS: Closed-End Funds
Exchange-Traded Funds (ETFs)
Financial Stability
International/Global
Money Market Funds RE: ICI Responds to Central Bank of Ireland Discussion Paper on a Macroprudential Approach for Investment Funds

ICI Global has filed comments with the Central Bank of Ireland (CBI) regarding the Discussion Paper: An approach to macroprudential policy for investment funds (Discussion Paper).[1]

ICI Global's response is summarized below:

In the Discussion Paper, the CBI presents its assessment of the systemic risks presented by investment funds and proposes an macroprudential approach to address these risks.

While the CBI's approach would apply to all investment funds, ICI Global provided comments specifically regarding the regulated funds industry, with a focus on long-term regulated funds.

ICI Global welcomed the CBI's effort to advance the debate on bolstering the resilience of the global financial system, but stated that the CBI is not focusing on what we see as a major risk to financial stability - the outdated market structure for the transmission of liquidity through the financial system. 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.

We challenged the CBI's assessment of three potential channels through which it asserts investment funds can generate systemic risk. As the first channel, 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, however. An actionable first-mover advantage is premised on the existence of material dilution. Based on ICI's analysis of 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.

The CBI identifies "informational frictions" as the second channel whereby investors in a mutualised vehicle overestimate the availability of liquidity in a fund as a potential systemic risk, where 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." 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 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, however. 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.

ICI Global also pushed back on the CBI's premise that high leverage is a driver of systemic risk across all investment funds. Acknowledging that high leverage may be an area for policyholders to examine in some contexts, we clarified that in the EU, US, and other jurisdictions, regulated funds are subject to requirements which limit their leverage.

We also challenged the CBI's assessment that it is primarily the collective actions of investment funds that can generate systemic risks, once again citing ICI's research.

The CBI proposes that the current regulatory framework for funds is insufficient and does not reduce the propensity of funds to amplify shocks. In response, we disagreed, highlighting the key features of existing frameworks and the structural features of regulated funds that limit risk and its transmission.

In addition to challenging the CBI's premises and assessments as they relate to regulated funds, we disagreed with the proposal that a macroprudential policy for investment funds is necessary to address systemic risk. Macroprudential policies as envisioned by the CBI are ill-suited for the regulated funds industry. Indeed, macroprudential policy is based on bank-centric concepts and approaches and are not appropriate for regulated funds. More specifically, 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.

Throughout the response, we highlighted that the risks the CBI is attempting to address appear to be market risks, rather than risks unique to funds, which suggests that policies focused on funds will not address the concerns.

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Notes

[1] For a summary of the Discussion Paper, see ICI Memo #35387.