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Submitted via online form: www.centralbank.ie/fundsurvey

Re: Discussion Paper – An approach to macroprudential policy for investment funds

Responses to questions

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

State Street Global Advisors ("SSGA") welcomes the discussion and the work initiated by the Central Bank of Ireland ("CBI") to get a better sense of the risks and vulnerabilities, as well as the potential interconnection, in the financial system. We appreciate the difficulty and novelty of this exercise and we welcome the opportunity to share our views at an early stage of this discussion. We will base our response on the regulated and UCITS funds structures which comprise the bulk of State Street Global Advisors' offering and, broadly, that of the Irish Funds sector. We have a series of objections, which we will address in the following questions, as regards the rationale behind a macroprudential regime for the funds sector, its potential scope and toolkit, as well as the potential policy implications that this approach could have for the funds sector and for funds' fiduciary obligations towards their investors.

Global discussion - While we recognize the leadership of the CBI in these matters and its mandate to preserve financial stability in Ireland, we would also like to stress that given the global scale and nature of the financial system, this inherently needs to be a global discussion, and that policy conclusions, if any, should be drawn jointly by the international standard setters. We note that work is ongoing at the level of the Financial Stability Board ("FSB") and International Organization of Securities Commissions ("IOSCO") and important progress has particularly already been achieved on liquidity mismatch, while more work continues on leverage.

Scope of the exercise - The emergence of non-banking financial intermediation ("NBFI") had a positive impact on the financial system by making it less dependent on the banking sector and by adding a healthy source of diversity in financing options. The increased diversity of the financial ecosystem improves market efficiency and functioning to the extent that the investment and trading choices of participants in the financial ecosystem become less correlated among each other. We welcome the fact that the Discussion paper ("DP") recognizes the benefits that the growth of the NBFI sector has brought to the financial system, especially with financial intermediation via the funds sector.

At the same time, the NBFI is a diverse and vast landscape, made up of different players with different business models and applicable regulatory regimes. The funds sector is only one part of this ecosystem and, especially in the UCITS and regulated fund space, it already adheres to high regulatory standards aimed at preserving investor protection and at reducing ex-ante vulnerabilities that might emerge from liquidity transformation risks. Funds' managers act fundamentally as agents for their investors and need to abide by the investment (or divestment) decisions of their investors. When it comes to liquidity issues in some specific markets and asset classes, one must look holistically at the structural functioning of the underlying market in question (e.g. the bond market or short-term funding markets) and at the drivers of liquidity demand and supply.

For these reasons, we believe that macroprudential policy cannot be targeted at the funds sector, 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.

More analysis is also needed on concepts such as fund cohort and on potential collective action issues in the funds sector as we explain in our response to Question 2. For what concerns the vulnerabilities and channels through which investment funds could potentially contribute to systemic risk, we would like to offer our thoughts on each one of them below, highlighting the strong prudential framework already in place at fund level which already helps in mitigating potential market instability.

Liquidity mismatch - Since the publication of the FSB's first set of Recommendations in 2017, the regulatory framework for the asset management industry has gone a long way to address liquidity mismatch and "first-mover advantage" risks in open-ended funds. We support the ongoing work at the FSB level to further strengthen this framework by ensuring that funds' redemption terms are consistent with their investment strategies and liquidity of portfolio assets. In Europe, there is a well-developed regime for managing fund liquidity risk in both the UCITS and AIMFD Directives, and this became apparent during the March 2020 financial turmoil, when cases of registered funds or UCITS funds failing to make timely payment on shareholder redemptions were extremely rare.

Moreover, strong liquidity management has always been part of fund managers' fiduciary duty, and asset managers have a wide range of recognized tools/best practices in place to manage fund liquidity and redemptions. This includes tools for managing day-to-day liquidity, as well as tools to cope with more extreme tail risk events and first-mover advantage risks. These tools range from ongoing monitoring of asset liquidity compared to expected redemptions, to more proactive measures in times of financial stress, such as swing pricing, redemption fees and gates. The ongoing work at IOSCO level on anti-dilution tools will further increase the robustness of the framework while maintaining fund managers flexibility in deciding when and which tool to apply according to the fund's characteristics.

Taken all together, this regulatory framework and the continuous supervisory dialogue go a long way in reducing first mover advantage dynamics which could lead to "excessive" redemptions, and thus reduce the need for asset sales at times of market stress. In doing so, the framework not only delivers on investor protection, but it also reduces one of the key vulnerabilities in the open-ended fund structure, i.e. the liquidity mismatch and the demand for liquidity at times of market stress, and therefore contributes to the overall stability of the financial system.

We would also like to add 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, starting from the unintended consequences of reforms introduced post financial crisis which reduced banks' balance sheet intermediation capacity in key asset classes.

Leverage - With respect to leverage, we note and support the work at international level which the FSB is currently undertaking. As stated in the latest FSB report on "*Financial Stability implications of Leverage in Non-Bank Financial Intermediation*", leverage across the NBFI sector is unevenly distributed, and more than 90% of on balance sheet leverage sits within a group that encompasses a range of miscellaneous entities from broker-dealers to holding companies and securitisation vehicles, but does not include investment funds nor Money Market Funds ("MMFs"). These figures are consistent with the IOSCO's "Investment Funds Statistic Report" from January 2023, which also recognized that leverage across the asset management industry remains low either through derivatives or direct borrowing.

UCITS and registered funds do not employ significant leverage, while for AIFs the DP rightly notes that via article 25 of the AIFMD, there is already in the EU a macroprudential tool in place through which national competent authorities can impose leverage limits. This tool was already activated in Ireland targeting the property funds sector. We have supported work by IOSCO and ESMA in the past to develop a consistent approach in the assessment of leverage-related systemic risk and on the calibration in the EU of leverage limits by national competent authorities, but we continue to believe that leverage limits should be imposed only in exceptional circumstances.

Furthermore, regarding the broader objective of assessing financial stability risks related to the use of leverage, regulators should consider the broader ecosystem, including for example the source(s) of the leverage. In this sense, addressing any discrepancies with regards to quality and consistency of data that NCAs currently receive could help regulators to identify areas in the system where there is an accumulation of risk. We therefore suggest a consolidation across borders and within ESMA of the data already provided in the context of the AIFMD reporting.

Interconnectedness – The DP considers both direct and indirect channels through which the funds sector could amplify risks to the rest of the financial ecosystem. Given the growth of the NBFI sector, we understand the need for the CBI to map and account for interlinkages within the NBFI sector, with the banking system and with the broader economy. When it comes to direct channels of exposure, we would like to point out that concentration limits for UCITS and MMFs are already in place in the current framework for funds and also across the banking sector.

Concerning indirect channels, we believe that system-wide stress tests which do not consider the funds sector in isolation can be an effective tool to aggregate data and improve the understanding of the behavior of non-bank financial institutions during stress market scenarios. We suggest that this supervisory approach would help avoiding singling out a specific class of counterparty such as investment funds, and would instead highlight that the funds sector itself can also be negatively impacted by developments originating in different parts of the NBFI and broader financial sectors, as it was the case of March 2020 when, for example, liquidity needs originating in other parts of the economy drove outflows from MMFs.

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?

The DP places a lot of emphasis on the term "fund cohort", using it to refer to funds pursuing similar investment strategies or investing in the same asset classes. This concept is then used to illustrate the collective action theory that could amplify systemic risk in the funds sector and it then serves as a basis to tailor additional policy measures to specific groups of funds. We believe that this concept is poorly defined and that stronger evidence is needed showing and quantifying collective action behaviors by investment funds. Further analysis is also required to demonstrate to what extent UCITS and registered funds in particular engage in procyclical behavior.

Fundamentally, the concept of fund cohorts doesn't seem to account for the fiduciary relationship that exists between fund managers and investors, whereby actions by funds are a function of the actions taken by individual and group of investors, notably institutional investors. Moreover, the concept of fund cohort risks overlooking the great degree of variability that even funds nominally investing in the same asset class display (e.g. among fixed-income funds, but also within MMFs, where experiences during recent stress events varied depending on the fund structure), while other multi-asset funds are not necessarily part of one strategy or asset class, further complicating efforts to identify fund cohorts. Instead, a focus on the investor base, rather than the fund cohort, could be more useful to explain funds' actions and liquidity demands.

Given the diverse nature of the funds sector and of investors, we caution against adopting prescriptive policy solutions which could end up exacerbating funds procyclical behavior, liquidity hoarding and finally the collective action problem that the CBI is trying to solve for. We would emphasize that our approach to liquidity management and risk mitigation during market stress events is based on our liquidity playbook, and it is fully independent of the actions taken by other fund managers and is not predicated on any expectation of support by public authorities. We would expect other managers to follow similar risk management practices, basing their response to market stress on independently calibrated procedures. In the pursuit of our fiduciary duty, our actions are primarily directed at protecting investors, and the flexibility built into the regulatory framework helps us in achieving that goal.

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?

As discussed in our response to Question 1, we believe that there is already an extensive amount of work undertaken at the international and jurisdictional level addressing the funds sector. This framework ensures not only the adequate investor protection but also the ex-ante reduction of the main vulnerabilities in the open-ended fund structure, namely liquidity mismatch, dilution and first mover advantage risks, which if not addressed could create a pressure on funds to engage in fire sales of assets thereby amplifying systemic risks. Leverage, where present in specific pockets of the fund sector, can be successfully targeted in extreme situations through the existing toolbox provided by the AIFMD.

In the EU, the most recent AIFMD review will further contribute to reduce concerns and any inconsistency among funds' practices with the introduction of a more stringent framework which, while recognizing that fund managers remain best placed to activate liquidity management and anti-dilution tools, introduces more consistent guidance across the sector.

One area in the regulatory framework where we consider that more could be done to prevent risks of contagion is the removal of the regulatory tie in the MMF Regulation between the imposition of liquidity fees and funds' weekly and daily liquidity requirements. During recent market stress events, these liquidity requirements became effectively a "bright line" that investors were highly sensitive too – removal of this link would thus mitigate the procyclical risk that investors are incentivized to redeem as the threshold is approached, thereby limiting the ability of MMFs to use these liquid assets in a stress scenario.

MMFs are also a clear example of the fact that if any limits exist in the current regulatory framework, these are related to problems that extend beyond the funds sector. In fact, in the case of MMFs there are also structural issues in the short-term funding markets that need to be considered from a financial stability perspective and which relate to the lack of intermediation and market-making capacity of banks and other broker-dealers especially at times of market stress. As noted before, we would suggest that regulators consider as well policies targeted at these structural issues in order to increase the supply of liquidity at times of stress.

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?

As noted in the DP, macroprudential policy as a regulatory approach developed in the banking sector in response to the Great Financial Crisis. We welcome the recognition by the CBI that this macroprudential framework cannot simply be replicated to the funds sector and that the assessment of systemic risk posed by investment funds is still evolving.

At the same time, we believe that an effective macroprudential policy cannot be targeted at the funds sector and that any financial stability discussion need to account for the broader non-bank financial intermediation ecosystem. We think that this discussion, before moving to policy recommendations, will necessitate further evidence gathering to test the hypothesis that UCITS and registered funds can display a "collective action problem" and therefore act as a conduit to systemic risk.

As explained above, we also think that the CBI's work should take into account the recent progress at the international level on both liquidity mismatch and leverage risks in the open-ended fund structure. More importantly, we invite the CBI 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. There are also questions as to how a macroprudential regime, with its focus on "fund cohorts" singling out specific fund groups and their investors, would coexist with the goal of broader investor protection and fiduciary duties.

We would also like to stress that contagion and unintended negative impacts can also stem from an over-regulated funds sector. In fact, limiting the financial intermediation capacity of investment funds can come at the price of preventing the positive added value that the funds sector offers to the economy in terms of financing opportunities, giving an incentive for risk to move towards less regulated parts of the NBFI sector.

Concrete examples are the impacts that over-regulation might have on Money Market Funds, on their capacity to act as cash and liquidity management tools for European investors and the provision of short-term funding for financial and non-financial companies; or the role of pension funds in financing productive investment. Over-regulation can also be particularly detrimental if single asset classes are stigmatized and made unattractive to large portions of the investment market.

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 discussed in previous responses, we would caution against any policy recommendation that would introduce new tools targeted at the funds sector, and especially including UCITS and regulated funds. A better regulatory approach should instead build on the already existing regime to close any potential gaps that may be identified, without introducing an additional regulatory layer with additional tools.

Some of the potential macroprudential tools explored in the DP already exist in the current framework and are consistently applied across the EU, namely price-based and quantity-based liquidity management tools and notice periods. The framework around these tools is deliberately flexible to allow fund managers, in a dialogue with their respective supervisors, to calibrate them to the characteristics of the fund. We would not support introducing more prescriptiveness and rigidity around these tools, especially for targeted funds cohorts, which could potentially intensify procyclicality instead of reducing it.

A careful costs and benefits analysis is even more important if the CBI is to consider the introduction of liquid asset buffers for specific fund cohorts. As noted above concerning MMFs, the current liquidity requirements ensured that MMFs held cash buffers which were more than adequate to meet elevated outflows during recent stress market events. The problem was not a lack of liquidity but the fact that the liquidity was rendered effectively unusable by the ‘bright line’: as funds approached minimum liquidity thresholds, investors felt incentivized to redeem to avoid the activation of liquidity management tools. Additional liquid asset buffers are unlikely to solve this and a better regulatory approach could be that of removing the link between minimum liquidity thresholds and liquidity management tools.

For other types of funds, mandatory liquidity buffers could have profound unintended consequences, for example they may prompt investors to react to stressed market conditions in a more pro-cyclical manner to avoid the consequences of a fund crossing those thresholds and can exacerbate vulnerabilities arising from structural liquidity mismatch, leading funds’ managers to sell more assets than otherwise needed to replenish the reduced cash holdings. Managers are instead better positioned to determine the appropriate level of liquid asset holdings for each the funds they manage.

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

We believe that the concept of interconnectedness of the funds sector to other parts of the financial system deserves more scrutiny and will need to be substantiated by a more detailed analysis before moving to policy considerations and we refer to comments made in previous responses.

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

We believe that to achieve the broader objective of assessing financial stability risks related to liquidity mismatch, the use of leverage and interconnectedness beyond the funds sector, regulators should give priority to solving any discrepancies with regards to quality and consistency of data. By consolidating data that NCAs currently receive, regulators could more easily identify areas in the system where there is an accumulation of risk. We therefore suggest a consolidation across borders and within ESMA of the data already provided in the context of the AIFMD reporting.

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

No response.