Asset Management & Investment Funds Update

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IMF Recommends CBI Regulatory Actions

On 27 July 2022, the IMF published a range of regulatory policy recommendations to the Central Bank of Ireland (**CBI**) following its periodic financial stability review of Ireland under the Financial Sector Assessment Program (**FSAP**). The FSAP review of the Irish market-based finance sector (investment funds and SPEs), one of several financial sectors reviewed by the IMF, resulted in the issuance of 15 separate recommendations, 13 of which were issued either solely or jointly, along with Irish government departments, to the CBI. Several of the recommendations relate to planned regulatory actions of which industry will already be aware e.g., finalisation of the framework for the treatment of pricing errors and prioritisation of the new individual accountability framework (see separate article on topic). However, the recommendations are a useful resource for fund management companies seeking to gauge regulatory priorities and likely areas of CBI focus in the near to medium-term. A summary of the key recommendations of relevance to fund managers is set out below.

1. *Liquidity management: CBI discussion paper on the horizon*

The IMF notes that, while a range of liquidity management tools (**LMTs**) are available to Irish funds, the CBI does not actively encourage funds to have a particular set of LMTs available to them at authorisation. The use of swing-pricing is positively referenced by the IMF as a tool which is used more widely in the UK and Luxembourg than in Ireland. The IMF recommends that the CBI progress publication of a "planned discussion paper on IF liquidity risk management" which should encourage more widespread adoption of LMTs, particularly swing pricing and anti-dilution levies. Increased CBI challenge of funds' use of LMTs at fund authorisation stage is also recommended. Liquidity risk management has been a regulatory focus for some time. ESMA co-ordinated a 2020 CSA on UCITS liquidity risk management and the CBI subsequently required UCITS mangers to review fund liquidity risk management frameworks as against the CSA findings by end Q4 2021 (see here for further details). Liquidity risk was also cited as one of the CBI's key risk areas in focus for 2022 in its Securities Markets Risk Outlook Report published in February 2022 (see here for further details).

2. *ETFs: AP concentration risk merits supervisory engagement*

The IMF notes the CBI's identification of concentration risk in the AP market with two of the most active APs being responsible for up to 90% of AP activity for certain ETFs of the dominant ETF provider in the Irish market which manages ETFs totalling 61% of AUM. While the IMF acknowledges the lack of evidence of market makers stepping away from market during the pandemic-related volatility in 2020, it recommends that the relevant CBI supervision teams engage with ETF providers "to ensure their arrangements with APs and MMs are robust and promote the smooth functioning of the sector, including in times of market stress." It also recommends closer co-operation between the CBI supervisors of funds and those supervising APs and MMs.

3. *Leverage: increased UCITS leverage reporting necessary*

The IMF recommends increasing the level of UCITS leverage reporting as while the reduced leverage reporting obligations on UCITS managers by comparison to those applicable to AIFMs may be partly explained by the more restrictive UCITS leverage rules, UCITS using VaR can employ significant levels of leverage. The IMF recommends that the CBI not wait for EU-driven amendments to the UCITS regulatory reporting regime, which are envisaged as part of the Commission's AIFMD review (see here for further details), noting that it would be "preferable for the Central Bank to take the initiative" to ensure it has a "more comprehensive and up-to-date picture of leverage within the UCITS sector."

4. *Delegation: extensive and systematic data collection warranted*

The IMF considers the extent of delegation by Irish fund management companies merits extensive and systematic data collections to facilitate both ongoing supervision and the CBI's understanding of the impact of "any tightening of requirements on delegation arising from the AIFMD review, in particular in respect of non-EU delegation." While the AIFMD review proposals provide for increased delegation reporting by both UCITS managers and AIFMs, the IMF recommends that the CBI consider introducing national measures if revised EU rules fail to close the data gap on Irish fund managers' delegation arrangements.

The IMF also recommends expanding data collection on investment funds' credit lines to give a clearer picture of how Irish funds would cope with unusually high levels of redemptions and/or unexpected portfolio illiquidity.

5. *CP86: follow-up on 2020 'Dear CEO' letters a must*

The IMF notes the CBI's acknowledgement of the disparity in CP86 compliance standards of fund managers which relocated to Ireland as a result of Brexit and those established prior to the publication of CP86. The IMF recommends the CBI continue its efforts to bring all fund managers to the same level, including through follow-up on the CP86 thematic review findings (see here for further details).

6. *UCITS eligible assets: increased convergence on approaches to bank loans, delta-one securities, and digital assets*

The IMF recommends that the CBI continue its work at ESMA in seeking to address remaining areas of divergence across Member States in the application of the rules on eligible assets, in particular with a view to developing common approaches to bank loans, delta-one securities and digital assets.

7. *MMF reform: CBI should take an active role in promoting IMF-recommended reforms*

MMF reforms recommended by the IMF to strengthen the resilience in the MMF sector include decoupling gates and fees from liquidity thresholds, increasing minimum liquidity thresholds, enhancing the quality and diversification of liquid assets, enhancing regulatory reporting and stress testing, mandating at least one LMT, imposing a minimum-balance-at-risk requirement, facilitating redemption-in-kind for institutional investors, and introducing industry-wide gates triggered by supervisory intervention or pre-defined criteria. The Commission's scheduled review of the MMFR was due for publication last month (see here for further details).

8. *Fund terminations: gaps in legislative framework should be filled*

The IMF recommends legislative amendments to address the long-outstanding issue of funds which cannot liquidate due to outstanding monies being held for uncontactable shareholders.

9. *PRISM: review of supervisory impact model for funds almost complete*

Funds are currently categorised as low impact under the CBI's risk-based supervisory model (**PRISM**). A CBI review of PRISM, including its impact rating model for funds, has been ongoing since 2020. The review is now at an advanced stage and a "proto-model has been developed to better capture the actual impact of the failure of a fund or group of funds (capturing the various dimensions of related risk) and to potentially utilize the model as a driver of supervisory engagement."

Next Steps

Progress on the IMF's recommendations to the CBI will form part of the next periodic FSAP of Ireland.

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