WILLIAM FRY

// ASSET MANAGEMENT & INVESTMENT FUNDS

IMF: We've fixed the banks "now we must do the same for investments funds"

October 2021

A further step towards adoption of a macroprudential framework for investment funds was taken on 17 September 2021 with the publication by the IMF of its recommendations for policy measures necessary to mitigate the financial stability risk posed by not just money market but also daily-dealing investment funds with less liquid holdings.

Background

The need for a macroprudential framework for investment funds has now been endorsed by a wide variety of regulatory, supervisory and financial bodies, including ESMA and the Central Bank of Ireland (see here and here for previous reports on topic). And while the parameters of such a framework have yet to be decided, last year's market volatility has certainly sharpened the minds of regulators and standard setters and the IMF policy recommendations provide useful insight into the likely areas of focus for future, financial stability-driven policy initiatives. Launching the paper, the IMF acknowledged that while *"we did not face another Global Financial Crisis last year the crisis exposed fundamental vulnerabilities [in investment funds] that could affect global financial stability."* The *"key message [in the IMF paper] is this: if we are to safeguard financial stability at the national and global levels, we need to boost the resilience of investment funds [by] further strengthen[ing] risk management, especially liquidity risk management".*

Policy recommendations for daily-dealing funds

The IMF recommendations for policy measures to address the financial stability concerns related to funds, other than money market funds (**MMFs**), target daily-dealing funds with exposure to low structural and highly procyclical market liquidity.

Swing pricing

Citing the benefits of swing pricing as a countervailing incentive against first-mover gains and as a measure to shield remaining investors, the IMF notes that its limited use in practice *"may argue for introduction via regulation to guarantee industry-wide adoption."* While acknowledging the limitations and operational complexities of implementing swing pricing, it is seen as an important measure for attenuating first-exit incentives for investors.

Mandated liquidity management tool waterfall

The IMF, expounding the benefits of a waterfall of liquidity management tools (**LMTs**) in addressing issues arising from the mismatch between daily-dealing funds and less liquid underlying holdings, notes that an effective approach may be to mandate a waterfall LMT to daily-dealing funds. The LMT waterfall would include minimum balance at risk (moderate shocks), redemption-in-kind (moderate to large shocks) and suspension

(large shocks) with the IMF recommending that regulators consult with industry to understand the most appropriate measures for inclusion in any mandated LMT waterfall.

Addressing leverage vulnerabilities

The IMF recommends enhancing regulatory oversight of the risks of significant levels of leverage on funds by filling gaps in regulators' data sets and positively cites the publication of IOSCO's leverage framework (reported on here) which is expected to increase the range and granularity of leverage disclosures by funds.

In addition to the above, the IMF also make policy recommendations for MMFs, many of which align with the recent ESMA consultation paper on MMF reform.

Next steps

The Central Bank has previously indicated its support for, and continuing involvement in, international efforts to adopt a macroprudential framework for investment funds and can therefore be expected to align its regulatory regime with recommended financial stability policy measures for funds. Further recommendations are also expected from the Financial Stability Board (**FSB**) which has previously committed to publishing policy proposals to enhance investment funds resilience. The FSB has scheduled publication of an update on this work for this month.

William Fry LLP | T: +353 1 639 5000 | E: info@williamfry.com

williamfry.com

This briefing is provided for information only and does not constitute legal advice

Copyright © William Fry 2021. All Rights Reserved In Association with Tughans, Northern Ireland www.williamfry.com