Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Feedback Statement to CP157: Macroprudential measures for GBP liability driven investment funds

Contents

Feedback Statement: Macroprudential measures for GBP liability driven investment funds

In November 2023, the Central Bank proposed to codify, and in certain cases augment, the yield buffer, initially outlined as a supervisory expectation in 2022 for Irish-authorised GBP-denominated LDI funds, as a macroprudential measure using Article 25 of the AIFMD. The yield buffer aims to strengthen the resilience of this cohort of funds to reduce the probability that they would amplify any future stress in the UK gilt market.

1. Introduction

The Central Bank of Ireland's (the Central Bank's) consultation paper on macroprudential measures for GBP-denominated LDI funds (CP157) outlined the Central Bank's proposal to codify, and in certain cases augment, the yield buffer requirement initially outlined as a supervisory expectation, in coordination with the Commission de Surveillance du Secteur Financier (CSSF), via an industry letter in November 2022. CP157 invited stakeholders to provide feedback on the proposals. Seven responses were received from stakeholders over an eight-week consultation period from 23 November 2023 to 18 January 2024. They included responses from alternative investment fund managers (AIFMs), a member of the public and a representative body for the funds industry.

The Central Bank would like to thank all respondents who took the time to make a submission on CP157. The insights provided by the feedback have fed-into the Central Bank's deliberations around the scope, calibration and application of the yield buffer measure. As the Central Bank and the CSSF are coordinating their policy response in introducing macroprudential measures for GBP-denominated LDI funds, this document also makes reference to feedback received by

Back to "Contents"

the CSSF in their aligned consultation. This feedback was shared with the Central Bank where it has prompted changes to the measures outlined in CP157, or provides more detail on similar feedback received from respondents. Therefore, it is recommended that this Feedback Statement is read in conjunction to the feedback published by the CSSF.

With CP157, the Central Bank asked questions on a wide range of topics surrounding the yield buffer measure. Respondents provided detailed feedback on the majority of topics covered in the consultation paper.

The core elements of the measures as put forward in CP157 are being retained in the final policy measures. Nevertheless, reflecting the feedback received, the Central Bank has judged that it is appropriate to make certain adjustments to the original proposals. These adjustments, and clarifications on the yield buffer, are outlined in full in the accompanying *Macroprudential Policy Framework for Irish-authorised GBP Liability Driven Investment funds* (hereafter referred to as the '*Framework Document*'). The most important of these adjustments are summarised as follows:

- **Definition of GBP-denominated LDI funds:** The original definition as per CP157 has been refined in order to better identify this cohort of funds. The definition now highlights that these funds are sensitive specifically to UK inflation and interest rates for pre-defined liabilities of their investors. Additional guidance around the definition has also been provided, such that a more detailed assessment can be made by managers as to whether their fund is within the category. The Central Bank expects AIFMs to take a prudent approach to determining whether their fund is in scope.

- **Liquidity guidance:** Further clarification has been added to make clear that the liquidity (in days) of non-eligible, non-cash assets for the calculation of the buffer should align with the settlement cycle of derivatives and repurchase agreement (i.e. repo) exposures. Fund managers should exercise a prudent approach to the inclusion of assets which are not cash or eligible collateral in the yield buffer, with such assets only accounting for a limited part of the total buffer.

Back to "Contents"

- **Non-UK rate sensitive assets:** Clarification is provided on the treatment of assets which are not sensitive to UK rates. Where assets are not sensitive to UK rates, funds should appropriately consider and risk manage these assets if they are to be included in the buffer. This requires regular assessment of the fund's resilience to simultaneous shocks to UK rate sensitive and non-UK rate sensitive segments of its portfolio. Furthermore, non-UK rate sensitive assets should form a limited part of the buffer.

The Feedback Statement is published to promote an understanding of the policy development process within the Central Bank and is not relevant to assessing compliance with regulatory requirements. For further details on the final package of the macroprudential policy measures, along with the key principles and elements of the framework, please see the Framework Document.

Central Bank of Ireland

29 April 2024

2. Feedback

2.1 Scope of the measure and definition of LDI funds

CP157 defined GBP-denominated LDI funds as "*Any fund whose investment strategy seeks to match the interest rate or inflation sensitivity of their assets to that of their investors' liabilities*".

CP157 proposed that the yield buffer apply equally to all GBP-denominated LDI funds authorised in Ireland.

<u>**Feedback**</u>

Respondents generally welcomed the LDI definition and the scope of the measures. It was noted that the definition should be broad enough to capture LDI funds that were involved in the 2022 UK gilt market crisis. One respondent also commented that conducting thematic analysis should encourage self-reporting by fund managers. One respondent suggested that the use of derivatives should be included in the definition.

Back to "Contents"

In contrast, a respondent to the CSSF noted that there are many different ways in which LDI investment strategies are described in investment objectives. While some of these may align with the definition, others do not. This may lead fund managers to decide that their funds are not in scope of the definition. They suggested that a definition should rely on balance sheet characteristics, rather than investment strategy.

However, other respondents to the CSSF noted that the definition was potentially too broad. They suggested the addition of balance sheet characteristics and a qualification that investor's liabilities should be pre-defined.

Regarding the scope of the measures, a number of respondents raised the fact that funds combine LDI and non-LDI investment strategies. This would typically be an issue for bespoke funds (i.e. those with one investor), but one respondent mentioned it could be an issue for some pooled funds as well.

Questions were also raised by respondents as to whether LDI funds with certain characteristics should or would be in scope. One respondent queried whether inflation-focused LDI funds should be in scope. They argued that as inflation expectations are less volatile than interest rates, and as inflation-focused funds' primary exposure is to inflation, these funds should be excluded from the scope of the measures. Another query was raised as to whether funds with GBP share classes, but non-GBP assets would be considered in scope of the LDI measures.

Back to "Contents"

Central Bank Response:

The Central Bank has decided to maintain the definition and scope outlined in CP157, but will provide additional guidance and clarifications to strengthen the definition, and make three minor amendments. As outlined in the consultation paper, the combination of assets that LDI funds use is not unique to them and any definition purely based on balance sheet characteristics would likely capture non-LDI funds. The Central Bank has therefore judged that a definition that focuses on the investment strategy of the fund is preferable.

However, as outlined in the feedback, the current definition could potentially result in funds being excluded from the sample. If an LDI fund manager determined the investment strategy of a fund based on a narrow interpretation of a fund's investment objectives they might not consider a GBP-denominated LDI fund to be within scope of the definition.

In addition, the initial definition was not explicit on whether a EUR or USD focused LDI fund with a GBP share class would fall within its scope. As LDIs do not pose the same risk to euro area or US sovereign debt markets, the Central Bank does not intend to capture LDIs with a GBP share class but no GBP exposures.

Acknowledging this feedback, the Central Bank has made the following amendments and clarifications:

- Provided additional guidance on the definition, including detail on the instruments that LDI funds typically use, on how fund managers should consider a broad range of information when determining whether their investment strategy matches the definition, and examples of alternative descriptions of the investment objectives of LDI funds found in LDI fund documentation (e.g. prospectuses).
- Amended the definition so that it is clear that it is sensitivity to UK interest rates and inflation that matters.
- Clarified that investors' liabilities are pre-defined.

Back to "Contents"

The Central Bank expects that fund managers will take a prudent approach in determining whether a fund is in scope of the definition. An exact definition for this fund cohort is difficult to develop, but it is expected that the definition, associated guidance, and analysis to date should provide sufficient information for managers to determine as to whether a fund is in scope.

The Central Bank has assessed that a definition that only focuses on funds using derivatives is too narrow in scope. Such a definition would exclude a substantial portion of LDI funds. As analysis has shown to date, funds using repo, rather than derivatives tended to be the most significant forced sellers of gilts.

The Central Bank has decided that inflation-focused funds are not excluded from the scope of the measures. While these funds' primary exposure is to inflation, their portfolios are still sensitive to interest rates. Gilt holdings have also been reported by inflation-focused funds. However, the buffer for inflation-focused funds is the same as for all other funds - it covers a 300 bps movement in rates – not inflation expectations.

The Central Bank considers that funds who combine a GBP-denominated LDI strategy and another strategy are within scope of the measures.

Finally, GBP-denominated LDI funds that are not reported to the Central Bank will face the same consequences as other funds which have breached regulation.

2.2 Liquidity guidance

CP157 proposed that funds '*should ensure that they maintain sufficient holdings of assets which are eligible to meet margin or collateral calls that result from adverse market circumstances, or assets which can be transformed into such eligible assets with requisite speed*'. In seeking feedback, the Central Bank queried whether '*requisite speed*' should be a specified number of days.

Back to "Contents"

Feedback

Most respondents disagreed with, or did not respond to, the idea of specifying a number of days within which assets should be transformed into eligible collateral in the liquidity guidance. Arguments against included that a sufficient evidence base to decide the number of days did not exist; that pushes to move to quicker settlement in financial markets may leave any specified number obsolete; and that holdings of assets which can be transformed into eligible collateral should vary with the terms of the individual repo and derivative agreements funds have with their counterparties. Where respondents provided a number of days, the difference between the two figures was 7 days, with the smallest being 3 days.

There were a number of suggestions in the feedback around the details of non-eligible assets in the buffer and their use. One issue raised by respondents was whether there should be a limit on the amount of non-eligible, non-cash assets held within the buffer. It was noted by one respondent that an even split between eligible assets and cash versus other liquid assets was unlikely to be desirable. It was also noted that a haircut should be applied to non-eligible assets. Finally, one respondent posited that non-eligible collateral in the buffer should only ever be transformed via repo, rather than asset sales.

Back to “Contents”

Central Bank Response:

The Central Bank has decided not to specify a minimum number of days for 'requisite speed'. As noted by respondents, settlement periods may change over time, and vary with individual repo and derivative contracts. Therefore, the Central Bank judged that it is appropriate to maintain a high-level, principle-based approach. The liquidity guidance in the Framework Document has been updated to reflect this, so that funds are required to ensure that the settlement period of their leverage (repo and derivative) positions aligns with the liquidity of non-eligible assets in their buffer.

The Central Bank has decided not to specify a maximum share of the buffer which such assets can account for, in order to avoid possible threshold effects. Rather, the liquidity guidance has been amended to set out broad parameters and require fund managers to exercise prudent judgment in how to meet these parameters.

The Central Bank has concluded that repo should not be the only way that non-eligible, non-cash assets are transformed into cash. The measures do not seek to prevent asset sales generally, rather their focus is to ensure that funds are not forced to sell assets in response to a shock. In addition, while repo secured on assets a fund owns can generate additional liquidity, it also has the potential to create additional liquidity demands if the value of the collateral falls.

2.3 Calibration of the buffer, including buffer level, third-party assets and usability

Consistent with the range initially set in the November 2022 industry letter, and as per the Central Bank's analysis, CP157 proposed to set the minimum yield buffer requirement at 300 bps. It was further proposed that the yield buffer calculation should only include assets on the funds balance sheet.

To promote the usability of the buffer, the Central Bank proposed that, on a rolling basis over the last four reporting observations, one of the reporting observations may be below 300 bps in exceptional circumstances.

Back to "Contents"

Feedback

Respondents largely agreed with the yield buffer minimum requirement being set at 300 bps. One respondent commented that the minimum was appropriate for weekly dealing funds, but that it was too low for funds with longer dealing frequencies, and too high for funds with shorter dealing frequencies.

Feedback on the buffer usability approach was broadly supportive. However, one respondent noted that while it should encourage buffer use, it cannot guarantee it, but that the possibility of buffer disapplication should help mitigate this. It was also noted that there should be a limit to the length of time such a deviation is allowed to persist, such that funds remain resilient.

The exclusion of assets owned by investors was agreed with by the vast majority of respondents. One respondent agreed that justifying their exclusion on the basis of preventing contagion to other assets was mostly valid, and posited that it could also help prevent the build-up of hidden leverage where the external buffer is used as a source of collateral for other leverage positions. Amongst those who did agree, it was noted that ultimately these assets would still be liquidated by investors in the event of a market stress event.

One respondent, and one respondent to the CSSF consultation process, disagreed with the exclusion of third-party assets. They put forward that their overall structure for managing investors' assets facilitates daily recapitalisation, supported by a constant balancing of investors' money between pools of assets with different levels of liquidity. As this structure requires that a portion of investors' assets outside the LDI fund are maintained highly liquid assets that can be transferred into the fund on an immediate basis, these respondents argued their funds should be able to maintain a lower buffer level within the fund. One respondent expressed that the key determinant of the crisis was not the level of the buffer but the speed with which funds could recapitalise, and this is what any regulatory response should focus on.

Another topic that various respondents provided feedback on was the composition of the buffer. Respondents noted that:

Back to "Contents"

- It should be made explicit that assets already committed as collateral for repo or derivatives cannot be included in the buffer.
- Guidance should also be provided on the treatment of assets whose sensitivity to UK interest rates is uncertain, that such assets may not be suitable for inclusion in the buffer calculation, and if they were to be excluded it would still be appropriate for them to be stressed.

Back to "Contents"

Central Bank Response:

Feedback received on the minimum buffer level was generally supportive, therefore, the Central Bank has not changed the buffer level proposed in CP157. The Central Bank agrees that funds with a dealing frequency longer than a week should consider targeting a buffer in excess of 300 bps, and the Framework Document has been updated accordingly.

The Central Bank has decided to maintain its position on the exclusion of third-party assets. While the argument that the speed of recapitalisation matters is relevant, it is equally the case that incorporating a structure that automatically responds to any deviation below 300 basis points with immediate liquidation of other assets is one that is more prone to transmitting stress. Furthermore, regulation should ensure a level playing field for funds. If an exception were to be made, it would privilege users of one structure, on the basis that this would allow their investors to place more of their portfolio in growth assets. By allocating more of their portfolio to growth assets, investors would be able to take on more risk, which would not be consistent with the overall intention of the measures.

In addition, Irish-authorised funds with an external buffer were not more resilient over the crisis relative to those without an external buffer. Gilt sales do not substantially differ when comparing funds with an external buffer to those without an external buffer where both categories of fund have similar internal buffer levels pre-crisis and the same type of leverage.

While the buffer usability approach cannot guarantee the buffer will be used, the Central Bank has judged that the structure of the rules, in addition to the messaging in the guidance, should be sufficient to allow for its use in exceptional circumstances. The approach does set a limit on the length of deviation below 300 bps that is considered permissible before it becomes a breach. By the following calendar month, the monthly average buffer should be greater than or equal to 300 bps.

Back to "Contents"

The feedback provided on buffer composition is welcome. These points raised are now reflected in the Framework Document. Funds should appropriately consider and risk manage assets which are not sensitive to UK rates to ensure they are sufficiently resilient to simultaneous shocks to UK rate sensitive and non-UK rates to be included in the buffer. Furthermore, such assets should form a limited part of the buffer. Where GBP-denominated LDI funds have derivative positions which are not sensitive to UK rates, they should not rely on the yield buffer as a source of liquidity.

2.4 Implementation period

CP157 proposed a three-month implementation period. The length of the implementation period reflected the fact that the measures are largely a codification of the yield buffer set out as a supervisory expectation via industry letter in November 2022.

Feedback

No objection to the three-month implementation was received.

Central Bank Response:

The Central Bank will proceed with a three-month implementation period.

2.5 Unintended consequences

The Central Bank does not expect significant transitional costs with the yield buffer measure, as GBP-denominated LDI funds have already undertaken significant steps to comply with the initial guidance outlined in November 2022's letter. However, the Central Bank acknowledged in CP157 that potential additional costs, beyond transitional ones, might accrue over time and therefore sought feedback.

Back to "Contents"

Feedback

Respondents pointed out potential additional unintended consequences. In particular, they highlighted that although the measures are aimed at avoiding pro-cyclical gilt sales, this cannot be always guaranteed. In stressed market conditions LDI funds seeking to avoid a breach after using the flexibility provided might de-leverage in a non-routine way (i.e. asset sales) and potentially introduce pro-cyclical dynamics.

Furthermore, respondents underlined that the measures might increase the possibility that funds re-domicile to other jurisdictions. It was also noted that increases in regulatory reporting for this fund cohort will lead to higher costs.

Respondents noted future unintended consequences will depend also on external factors that go beyond LDI strategies. For example, changes may occur in the gilt market that affects the demand and supply of gilts.

Back to “Contents”

Central Bank Response:

In CP157, the Central Bank proposed to codify, and in certain cases augment, a measure that funds have already made adjustments to comply with, so any initial costs have already been absorbed. Nevertheless, additional costs and unintended consequences may materialise in future.

The Central Bank acknowledges that ensuring there is no risk of fire sales occurring is unlikely to be achievable. However, it has also determined that the measures would make any pro-cyclical sale less likely given the flexibility the buffer usability approach provides. The usability approach should provide flexibility to managers without triggering fire sales, and the possibility remains for the Central Bank to dis-apply the measure if it is judged that returning to a 300 basis point average across the sector would amplify stress in financial markets.

It is important to note that the Central Bank measures are broadly in line with other international and European regulators. The codification of the yield buffer outlined in CP157 is undertaken in conjunction with the CSSF and is broadly in line with the guidance of The (UK) Pension Regulator (which applies to pension fund investors in LDIs).

In addition, the measures will be reviewed periodically, which will involve an assessment of the broader impact of the measures.

2.6 Additional feedback

CP157 concluded with a general request for feedback on topics not covered in other questions. This section collates that feedback, and responds to it.

Feedback

Respondents provided feedback on a wide range of topics, including the place of the measures in a broader policy context, requests for amendments to the measures outlined in the consultation paper unrelated to other topics, requests for clarifications on certain items, and general observations about the measures.

Back to "Contents"

One respondent provided many observations and suggestions on how these measures fit into a broader policy context. They observed that now is an opportune time to formalise these measures, as market participants are currently experiencing relatively calm financial conditions. They also suggested that these measures should be revisited when discussions on international macroprudential policy for non-bank financial intermediaries begin to produce policy recommendations. Furthermore, if the Central Bank was to change its rules for LDI funds in response to this, it was suggested that a full cost-benefit analysis should be conducted. Finally, they suggested that metrics for considering the effectiveness of the measures should be decided in advance of their implementation.

Amendments to certain text were requested on the basis that their phrasing was overly burdensome or may be counterproductive. One comment highlighted that stating 'funds should *ensure* that their investors are prepared and able to meet capital calls' puts an unreasonable burden on the fund. Rather the fund should make investors '*aware*' that they will need to meet capital calls in stressed and normal conditions. A request was also received to change the word '*maintaining*' in 'LDI funds should consider *maintaining* their yield buffer above 300 bps' as it may create expectations from LDI investors that the buffer cannot be used.

Feedback to this question also contained requests for clarifications and guidance. Respondents requested clarity on requirements for fund managers to notifying the Central Bank when the yield buffer falls below 300 bps, and how such deviations should be rectified. Another request was to clarify under what situations funds are required to notify the Central Bank, including an explicit definition of what 'prolonged and/or substantial' means. It was noted that in its absence, different fund managers may arrive at different conclusions. A request was also received to provide guidance on the speed with which deviations below 300 bps should be rectified.

Feedback was also received from an industry body on behalf of a working group of fund depositaries. It outlined a view on the role fund depositaries should play in monitoring compliance. They communicated that depositaries should not be expected to independently replicate the yield buffer calculation, but they would confirm that AIFMs have a process in place to calculate the yield buffer and notify the Central Bank of any breaches. They also noted that they may play a role in assessing that buffer usability is being utilised in accordance with the regulation.

Respondents did raise questions on the new reporting requirements and whether LDI reporting would be made public. A respondent questioned how monthly averages would be reported in a weekly template. A request was also received as to whether data on the yield buffer collected in the LDI fund monitoring template could be published on the Central Bank's website, on the basis it may improve market discipline and general knowledge of the resiliency of this sector.

Back to "Contents"

Central Bank Response:

The suggestions and observations on how these measures fit in a broader policy context are welcomed by the Central Bank. These suggestions will be considered as the measures are implemented and in subsequent periodic reviews.

The requests for amendments to certain text have been considered.

The requests for clarification around notification requirements when the buffer deviates below 300 bps have been considered. The Framework Document has been updated to provide greater clarity on this point. However, the Central Bank is prioritising the avoidance of cliff-edge effects and ensuring buffer usability, and therefore will not be providing a specific definition of either 'substantial' or 'prolonged'. The guidance does outline that funds availing of the buffer usability approach are not required to proactively notify the Central Bank, as this will be captured in the monthly monitoring template.

There will be no inconsistency between required fields (e.g. monthly averages) and reporting frequency, as the template will move to a monthly reporting frequency by the end of the implementation period.

In terms of publication, the Central Bank expects that it will be publishing relevant analysis and trends periodically in relevant publications such as the Financial Stability Review or the Market-Based Finance Monitor.

3. Next steps

Further development of the macroprudential framework for investment funds will remain a key objective of the Central Bank going forward. In-keeping with the Central Bank's strategic commitment of strengthening the resilience of the financial system, it is important to continue to identify potential vulnerabilities in the financial system, including investment funds and other non-banks, and take actions to

Back to "Contents"

safeguard resilience. This will ensure the financial system is in a better position to support households and businesses, both in good times and in bad.

A Framework Document, which sets out the specific framework design of the macroprudential measures for Irish-authorised GBP-denominated LDI funds, has been published in conjunction with this Feedback Statement. The Central Bank will continue to engage with LDI managers as part of its supervisory engagement to assess firms' progress in implementing these measures for enhancing the resilience of LDI funds.

Appendix

Table 1 | Table of submissions received

Type of body	Name of respondent
AIFM	Blackrock
	Insight Investment
	Legal & General – Investment Management (LGIM)
	Mercer
	State Street Global Advisors Europe Ltd
Representative Body	Irish Funds, on behalf of the Irish funds depositories working group.
Member of the public	Laura Kodres