Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Funds Supervisory Strategy & Outlook

30 September 2022

September 2022

Introduction

Thank you to the organisers for the opportunity to attend today. When reflecting on my remarks and what areas I might cover it was difficult to know where to start. But the common theme that I kept coming back to was the level and pace of change in the asset management sector, it is unrelenting.

A quote attributed to the Greek philosopher hera-klai-thus seems particularly apt – that *"everything changes and nothing stands still"*. That is certainly the case in financial services now more than ever.

Responding to that level and pace change is a key part of the Central Bank's current strategy which became effective in January of this year. That strategy has four connected themes –

(i) Transforming,
(ii) Open & engaged,
(iii) Future-focused,
and
(iv) Underlying all three of these themes is the concept of safeguarding

This strategy is ambitious and represents an "evolution" of the Banks approach, while building on prior organisational strategies, it seeks to ensure the Central Bank is set up to respond to all of the forthcoming changes– be they legislative, regulatory or sector changes.

From a Funds supervision perspective, this Bank strategy is also informing our approach to the regulation and supervision of the sector and provides a helpful framework for me to explain how we are positioning ourselves to be prepared for future challenges and emerging risks.

I will focus on the first three pillars of that strategy of transforming, open and engaged, and future focused.

Turning to "Transforming" first, in this context the Central Bank's strategy calls out its desire to *"transform…..to be a more agile, resilient, diverse and intelligence-led organisation"*. The Funds Supervision Division is at the forefront of this transforming theme.

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Before saying more on that, it is worth reminding ourselves of how much the sector has transformed over the last number of years

1. From a growth perspective, total AUM in Ireland, currently exceeds €3.5trn, this is up from €1 trillion under 10 year years ago – the number of funds authorised stands at well over 8,000, up from 5,000 over the same period.

2. But they are just the high level numbers, in addition to this growth, there has been significant structural changes. These have been driven by a number of factors, including
    a. the impact of Brexit on the sector,
    b. the growth in the influence and role of ESMA, in setting supervisory focus
    c. but there has also been significant evolution across the sector since the last financial crisis, such as an increase in the obligations, responsibility and requirements, driven in no small part by expanding regulatory initiatives such as AIFMD II, SFDR, MiFID, DORA, MICA etc. the list goes on. This has resulted in firstly, material changes to the level of resourcing required to effectively meet those requirements, and secondly the emergence of new business models to meet those demands.

An example of this transformation is across fund management companies – both from a UCITS and AIFMs perspective – which has seen significant changes over the last three years. To provide some context, there were 359 fund management companies authorised in Ireland in 2019, 214 of which were self-managed investment companies, today that number has now decreased to only 18 – a fall of approximately 90% - and this figure is expected to further decrease as more funds covert to externally managed entities. As an aside, as you will be aware, the Central Bank has consistently taken the view that it does not favour one business model over another provided that the entities involved are able to meet our regulatory expectations, including from a resource point of view.

That move away from the self-managed fund structure has resulted in a significant growth in a small number of management companies, managing larger number of funds with potentially more complex relationships (including overseeing an increased number of diverse delegates). The scale of firms with these characteristics has grown significantly since 2019 and they now have AUM in the region of €540bn. That reflects a 240% increase in AUM since 2019.

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From a supervisory perspective, this evolution gives rise to increased concentration risk.

3. Another transformation worth calling out is the growth in the level and extent to which fund management companies are providing MiFID services such as Individual Portfolio Management (IPM). In 2019, there was approximately €19bn in assets under management for IPM services, this figure has now increased to €432bn. From a regulatory perspective, we need to ensure management companies remain prudentially sound reflecting the nature and scale of all their activities.

Therefore, as a result of all these developments and transformations, the very nature of the sector we supervise has changed considerably in just three short years. This is why we are evolving our approach to how we supervise the sector. This evolution includes,

1. greater focus on data lead supervision and use of thematics or sector analysis;
2. increased focus on potential systemic risks from funds; and
3. importantly, an increased emphasis on fund management companies when we are considering underlying Fund risks.

These changes reflect our recent experience of supervising exceptional market events such as the COVID-19 market shock, the disruption caused by the Russian invasion of Ukraine and even this week's market volatility in the UK gilt market.

By focusing on fund management companies when we are approaching the underlying fund risk, this allows the Central Bank to follow the risk, both from an individual firm perspective, but also across the sector and helps to ensure engagements with supervised entities are as effective as possible. That is not to say that a fund – and its board - will not be subject to on-going enquiry from the Central Bank, instead, our intention is to direct greater attention towards management companies and through those interactions supervise the underlying funds more effectively.

The increased focus we are placing on management companies also aligns with the recent work the Central Bank has undertaken to strengthen the regulatory framework under which these firms operate via CP86. As many of you will be aware we recently carried out the latest survey on this topic. Our intention is that the findings of this survey will help establish whether some of the issues raised in our

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industry letter from October 2020 have been addressed. [1] The findings will also inform future regulatory developments in this area – including potential updates to the Central Bank's rules and guidance for management companies.

Moving onto the strategy of "Open & Engaged"

The Central Bank's aim is to *"build trust and understanding…through stronger engagement with the public, stakeholders and peers*." Throughout 2022, the Funds Supervision Division has been actively progressing a number of new initiatives in this area and we will be continuing to pursue others as we move through 2023.

Creating an effective and efficient authorisation process for investment funds and fund service providers is our key aim. One which allows us to follow the risk.

A properly functioning gatekeeper process is a core part of our supervisory strategy.

- not only in terms of ensuring that firms and funds meet our high regulatory standards,
- but also in terms of ensuring that any issues which are identified at the gate are investigated to ensure the maximum effectiveness of our supervisory resources.

We will continue to prioritise those funds which have a retail focus as we have always done, and many of you will be aware we have reinstated authorisations for most Qualified Investor AIFs on the basis of confirmations (subject to a proportion of those funds undergoing quality assurance reviews post authorisation).

Over the coming months, we will continue to engage with stakeholders around further enhancements to our authorisation process.

1. Initially this will focus on authorisation process for UCITS and Retail Investor AIF
2. Later we will be engaging around the approach to Qualified Investor AIFs.

In addition to these formal stakeholder engagements, a core part of our strategy is to be open and engaged with applicants. I mentioned earlier about the need to

[1] See Dear Chair letter to fund management companies dated 20 October 2020.

Available here: https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/dear-chair-letter---thematic-review-of-fund-management-companies-governance-management-and-effectiveness---20-october-2020.pdf

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efficiently deploy our supervisory resources. We will continue to examine our engagement model with firms and look at how we can optimise those interactions to not only examine risks facing a particular firm but also to understand the firm's planned pipeline of product launches and how those may impact on our gatekeeper processes.

We intend to engage more frequently with firms on that basis and would welcome engagement from firms in advance of major product initiatives or on a regular basis to discuss forthcoming fund launches.

Future-Focused

Finally, in terms of being future-focused, I thought I should share key risks and areas of focus for the Funds Division over the next 12-18 months. While the three I will outline are all quite different, the commonality they share is that they all represent significant challenges for both market participants and for regulators.

1. The first is recognising the **geo-political and economic environment** in which we operate. This is likely to bring more, rather than less, uncertainty over the months and years ahead. This uncertainty can come in a number of forms such as
    a. geo-political shocks – like the one following Russia's invasion of Ukraine;
    b. the macro economic outlook, which looks certain to pose challenges for firms and investors over the coming period; and
    c. structural and regulatory challenges due to the post Brexit landscape driving legislative and regulatory evolution

    There will be a need for all of us to be agile to whatever changes (as of yet unknown) may come in the future. The last number of years has shown us that firms and regulators alike, must be prepared to respond to unfolding events at short notice with a high degree of resilience available to weather such shocks.

2. The second area I would identify relates to a key priority of the Central Bank heading into 2023, that is of course the area of **sustainable finance**.

    We are aware in a European context the framework is not perfect. There remain challenges including:
    - clarity surrounding requirements;
    - data availability issues; and

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- differing approaches to implementation and challenges with how the European framework interacts with national frameworks

But one thing is certain – a lot of regulatory and industry time is going to need to be dedicated over the coming months and years to finding those fixes in the context of the ESG agenda.
Our focus will include

1. fund and firm disclosures;
2. the integration of sustainability risks within firms risk management frameworks; and
3. portfolio level analysis to understand the changes which funds are undertaking as they adapt their investment policies and strategies.

We will shortly be issuing a publication in this area which will set out certain expectations around fund disclosures as they prepare to make the updates required by the SFDR level II which comes into effect in January 2023. This will also outline a supervisory roadmap to identify in more detail our planned areas of focus over the next 12 to 18 months.

3. The third and final area I wish to identify is that of **digitalisation**.

This year has highlighted the potential vulnerabilities of digital assets such as Bitcoin. But regardless of market volatility – the asset class is increasingly intertwined with the traditional financial system and is not going away. As a result, we must find ways for digital assets to appropriately interact with the traditional financial system.

In due course, this may involve encouraging or nudging greater use of regulated digital assets such as under MiCA when that legislation is in effect.

In the interim, increasingly regulators have commenced extensive sharing of information and exchanging of views on approaches to these digital-assets

The recently published white paper from Irish Funds on crypto assets is a good example of the forthcoming changes– both in terms of:

(a) the assets in which funds invest;

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(b) but also in terms of how funds and fund service providers use technology in the provision of investment products.

From the Central Bank's perspective we have made steps in this regard in the context of professional investor funds in Ireland but there is more to do.

Conclusion

Let me conclude there. I hope my remarks today have given you a good sense of the Central Bank's strategy and how this is informing our strategy for the supervision of the funds sector.

The steps we are undertaking in the Funds Supervision Division (across the themes of transforming, open & engaged and future-focused) are all designed to support the aim of continuing to strengthen the resilience of the funds sector while ensuring the best interests of investors are protected.

I started this speech by quoting about a change, I might end on the same topic, from another Greek philosopher, Socrates, *"the secret of change is to focus all of your energy not on fighting the old, but on building the new."*

Thank you for your time

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