Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Funds Industry Engagement Event
Covid-19 Impact on the Funds Industry
25 September 2020

Outline

- Welcome & brief introduction
- Macrofinancial perspective on Covid-19 and the funds sector
- Reflections from our supervisory engagements during Covid market events
- Potential future policy developments
- Closing remarks

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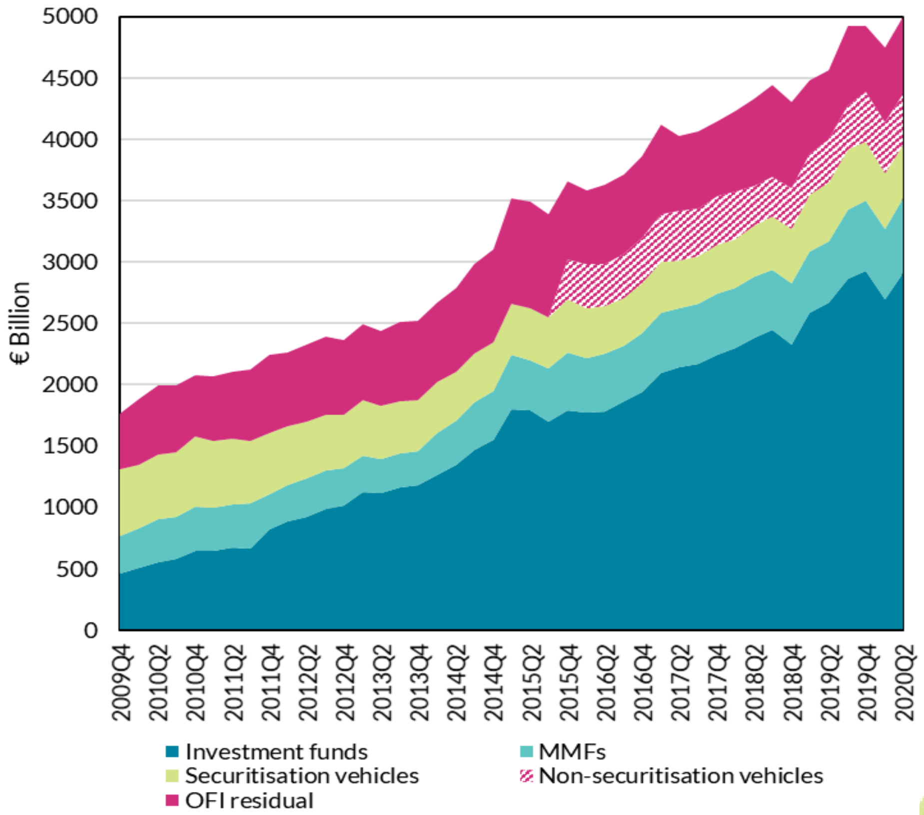
The market-based finance sector has grown rapidly in recent years

- The market-based finance sector, both domestically and internationally, has grown rapidly in recent years.
- Plethora of diverse business models domiciled in Ireland, including investment funds, securitisation vehicles and non-securitisation vehicles.
- The market-based finance sector in Ireland is dominated by investment funds, including money market funds.
- Investment funds provide valuable alternative to bank financing, both globally and domestically.
- Like all forms of financial intermediation, market-based finance can contribute to a build-up of financial vulnerabilities.

Market-based finance sector domiciled in Ireland



Source: Central Bank of Ireland, ECB SDW.

Potential structural vulnerabilities that can contribute to amplification of shocks in times of stress

Liquidity mismatches

Open-ended funds with short redemption periods and investments in less liquid assets could be susceptible to the risk of large redemptions in times of stress, requiring sales of less liquid assets over a short period of time.

Leverage

When asset prices fall in times of stress, highly-leveraged funds may seek to sell assets over a short period of time to keep their leverage at a target level or be forced to do so by their creditors.

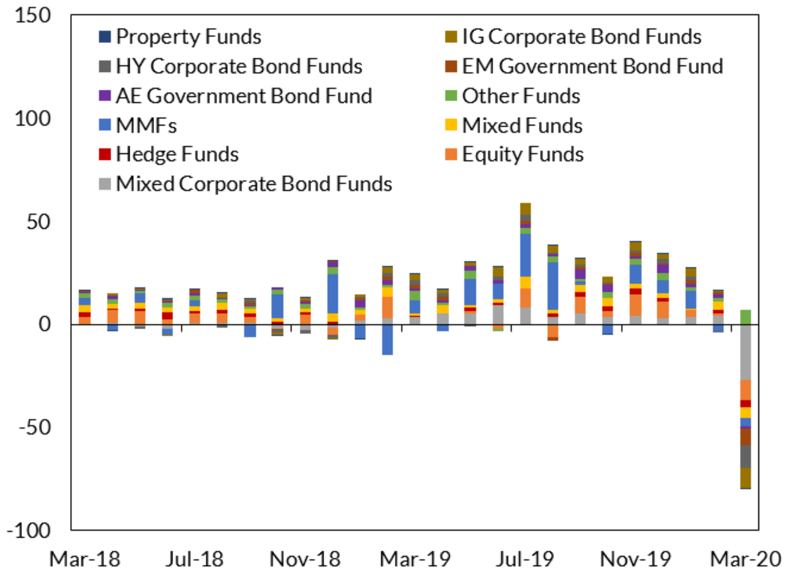
‘Fire sale externalities’

Actions in response to shocks may be perfectly rational from the perspective of individual institutions but can have adverse, system-wide implications, disrupting key markets and the provision of financing to other financial institutions or to the real economy.

COVID-19: Amid a global 'dash for cash' and flight to safety, parts of the investment fund sector saw large redemptions in March

- At the onset of the COVID-19 shock, parts of the global funds sector – including funds resident in Ireland – experienced a sharp increase in redemptions and challenges in liquidity management.
- At an individual level, the vast majority of funds managed to meet investor redemption requests, with limited use of tools such as suspensions and gating observed.
- However, this needs to be seen in the context of unprecedented central bank interventions that played a key role in restoring market functioning.
- Increasingly, focus is turning to the potential for the collective behaviour of funds to add to market-wide pressures in periods of stress.

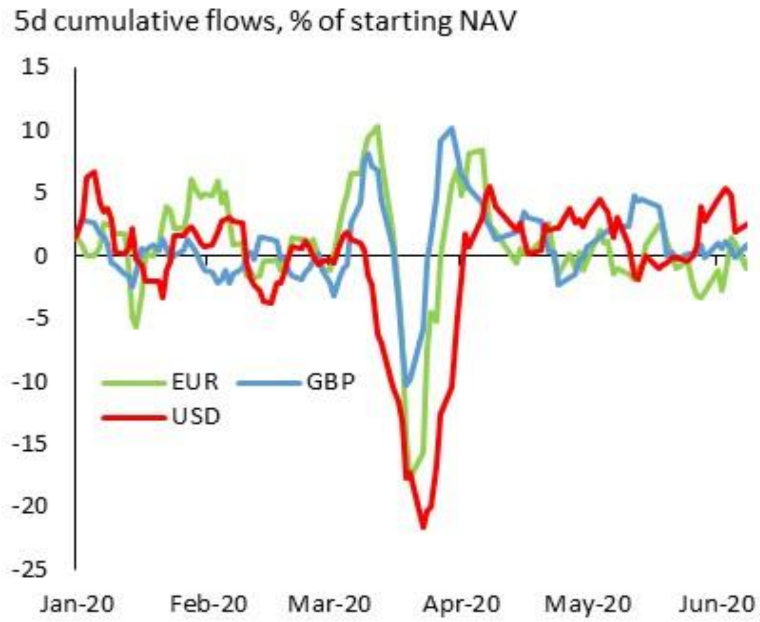
Significant redemptions from open-ended funds with short redemptions periods



COVID-19: Some MMFs particularly vulnerable during the initial ‘dash for cash’ and flight to safety

- MMFs with investments in <u>private</u> sector debt saw a sharp increase in redemptions and a deterioration in asset liquidity.
- MMFs with investments in <u>public</u> sector debt (mainly USD public debt MMFs) recorded large inflows over the same period.
- Risk of spillover of liquidity stresses to other parts of the financial system if some MMFs were unable to meet redemptions.
- Concerns over LVNAVs were amplified by the possibility they may breach the 20bps regulatory collar.
- Central bank policy measures key in restoring short-term money market functioning.
- Since the initial shock in March, Irish MMFs have reduced the maturity of their asset holdings.

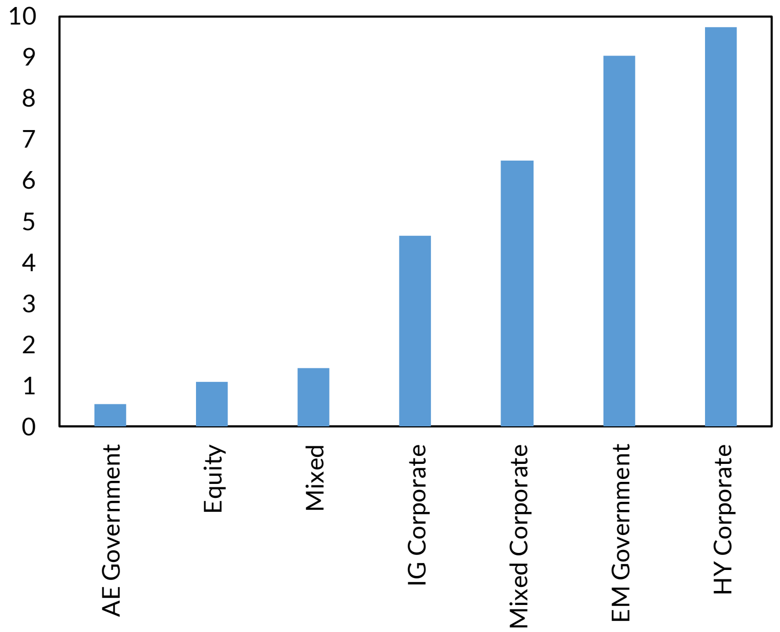
Flows into Irish-resident LVNAV MMFs



COVID-19: Funds with short redemption periods and investments in less liquid assets saw particular liquidity management challenges

- As a share of AUM, redemptions were highest amongst funds with exposures to less liquid instruments (eg corporate and EME debt).
- The corporate bond market in particular saw a sharp deterioration in market liquidity at the onset of the COVID-19.
- Corporate bonds funds responded to redemption pressures by selling assets, which may have contributed to further deterioration in market liquidity and asset price pressures.
- Central Bank interventions have led to significant improvements in market functioning in corporate debt markets.

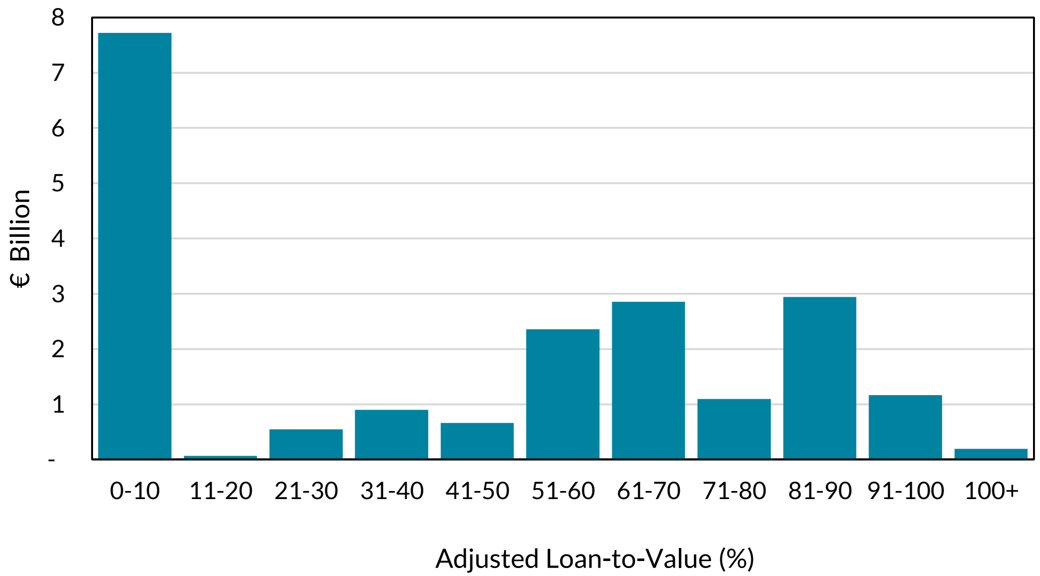
Funds with investments in less liquid assets proved particularly vulnerable to redemptions (March 2020, %)



COVID-19: Real estate investment funds with high leverage more vulnerable to commercial real estate price falls

- Investment funds now hold a substantial share of the Irish CRE market.
- Relative to the UK fund sector, liquidity mismatches in Irish-resident funds that invest in CRE are more limited, given their dealing frequency / notice periods.
- However, some Irish-resident real estate funds have higher levels of leverage, making them more vulnerable to potential falls in CRE prices.
- COVID-19 shock has already led to some adjustment in CRE valuations (and an increase in valuation uncertainty).

Risks stemming from leverage in REIFs (Q4 2019)
Distribution of property assets by Irish real estate funds' Loan-to-Value ratio for bank loans



Summary

- Individually, majority of funds were able to meet redemptions at the height of the shock, without recourse to tools such as gating or suspensions.
- At the same time, some of the sector-wide dynamics previously flagged as concerns by financial stability authorities (e.g. selling of less liquid assets to meet redemptions) were also evident during the stress.
- Central bank interventions – and broader actions taken by governments to cushion the impact of the shock on households and businesses – played a key role in stabilising markets.
- While market conditions have improved, uncertainty remains highly elevated. Enhancing preparedness for potential re-emergence of near-terms shocks remains key.
- The Central Bank is actively engaged with international stakeholders on risk identification and consideration of the sector from a macroprudential perspective.

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Supervisory Perspective

Recent COVID events best seen as an episode in our engagement on a range of priority supervisory themes:

- The need for adequate resources and expertise within the Irish regulated entity to oversee its operations (the 'CP86 Theme')
- The need to pay closer attention to managing liquidity risks (the 'Liquidity Risk Theme')
- The importance of high quality information for boards, investors and regulators (the 'Data and Transparency Theme')

So, what did we observe during this episode.....

On the 'CP86 Theme'

- **Business continuity plans worked well, but were fragile** in the face of harsher COVID impact overseas. Capacity to replace reliance on outsourcees was patchy.
- Heavy **reliance on group policies/processes**, and not always clear how those policies/processes would apply to the Irish entity.
- The **reliance by Irish executives on other entities** (e.g. personnel in the Investment Manager/group offices) to explain processes and strategies was extensive, and in some instances seemed near total.

Lesson: Irish FMCs must ensure that they have sufficient experienced resources in place to adequately oversee all of its activities, <u>including during time of crisis.</u>

Lesson: Irish FMCs need to be able to formulate their own approach to managing the situation and control the steps to be taken to do so.

On the Liquidity Risk Theme:

- With the exception of some funds, the **management of redemption requests** over this period was addressed. But this has to be considered against the backdrop of the extraordinary support provided by governments and central banks to the markets in which these funds invest.
- A **lack of preparedness by some firms** in respect of the possibility of a liquidity event such as an absence of thresholds for escalation or defined escalation lines up to the Irish FMC.
- **Playbooks were either non existent or could not be deemed of a sufficient** standard e.g. in the case of money market funds.

Lesson: Irish FMCs must have planned for its worst case scenarios and be prepared for future shocks, with trigger alerts in place and defined escalation paths to the Irish FMC.

Lesson: Operational playbooks need to be in place and ready to be executed in worst case scenarios.

On the Data and Transparency Theme

- **Positive and timely engagement** regarding the implementation of **additional Daily MMF reporting** at the height of the crisis.
- However we did encounter **delays and pushback** from entities based on non-availability of resources or data.
- FMCs did not always factor in timelines for **investor notification and Central Bank approval** of potential changes to funds and its supporting documentation

Lesson: You need to be able to access key information as and when it comes to be needed

Lesson: Factor in Central Bank approval and Investor Notification Timelines

Conclusion on these lessons

For firms to be able to continue to promote the benefits of the delegated model in a credible way, significant improvements are needed on these basic topics so that the leadership and oversight by the Irish entity is meaningful and effective.

The good news is that the framework is there – but it needs to be implemented properly. Some are doing this better than others, but overall we found a need for significant improvement in almost all cases

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Potential Future Policy Developments

MMFs

- The challenges MMFs encountered in March arose due to the unanticipated shock to the global economy and the associated stress in money markets.
- We must also consider what effect market structure and the current regulatory framework had during this period of market stress.
- IOSCO's Financial Stability Engagement Group (FSEG), working with the Financial Stability Board (FSB), has launched a group looking at MMF resilience.

Property & Corporate Bond Funds

- Liquidity management is a particularly important component of managing Property and Corporate Bond Funds during periods of stress.
- In May, the ESRB issued a recommendation to ESMA on liquidity risks in investment funds.
- NCAs are now reviewing information in relation to property and corporate bond funds to assess their preparedness in case of a new liquidity stress episode.

Liquidity Management Tools

- The use of liquidity management tools (LMTs) throughout the Covid-19 market turbulence period has been a particular area of focus for regulatory authorities.
- Data collection exercises on the use of LMTs during the crisis have further highlighted the need for a harmonised LMT framework.
- In August, ESMA issued a recommendation to the European Commission highlighting areas to consider during the forthcoming AIFMD review, including the need for a harmonised legal framework for LMTs.

Macro-Prudential Toolkit

- IOSCO and the FSB have signaled the potential need to develop a macro-prudential framework for the non-bank sector to mitigate the need in future for central banks to intervene in a crisis.
- Policy makers are expected to consider the development of the macroprudential framework for market-based finance.
- In Europe, the European Systemic Risk Board has been, and is expected to continue to be, focused on investment funds from a macro-prudential perspective.

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