Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Discussion Paper
An approach to macroprudential policy for investment funds

Feedback from Association française des investisseurs institutionnels (Af2i)

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Question 1: Do you agree with the above assessment of the potential channels through which investment funds can generate systemic risk?

Yes, given the size of the assets under management both globally and in a number of countries, and the fact that most of them are invested in real assets, the fund actions as a whole can create a situation which can, as the document defines it, "disrupt the provision of financial services through a depreciation of all or part of the financial system, with serious negative consequences for the real economy".

Two comments:

1) The definition of "systemic risk" used in the document and recalled on page 4 is too restrictive because it limits this risk to the scale of its supposedly significant consequences. However, to be able to define a macroprudential framework encompassing the entire investment fund sector, it would have been interesting to use the scientific definition of the word "systemic". This assumes that the investment fund sector constitutes a system, or a subset of a system in the sense of the general theory of systems. Qualifying a risk as systemic implies that an imperfection in the construction of funds or in their regulations can lead to damage resulting from an external shock or from the voluntary or involuntary triggering of an endogenous mechanism that can, but does not necessarily, lead to a general imbalance.

2) The analysis of the transmission mechanism (p21) and the adverse effects on the so-called real economy, i.e. the production and consumption of non-financial services, needs to be completed. While the impact on the real economy of the occurrence of a crisis is the reason for the reinforcement of prudential measures specific to the fund management business, the ability of the authorities, and of the central bank (ECB) in particular, to intervene must also be assessed (see p30). The decisions taken by these players have proved effective in limiting the impact of potential shocks in recent crises, even in the presence of investment funds of equivalent size. This would not require any other provisions specific to the fund sector.

Back to “Contents”

The main issue is therefore to define the origin of this systemic risk linked to funds, since this risk, as indicated in the document on page 13, has multiple facets.

For Af2i, this risk is not limited solely to liquidity or leverage risks.

It should be noted in advance that what the Central Bank defines as the main "underlying vulnerabilities in investment funds (P18)" are in fact the two main arguments underpinning the fund sector's justification for investing directly in the markets.

However, Af2I draws attention to other sources of vulnerability:

- the management style, whether chosen or forced, which encourages managers to act in an identical way, i.e., to buy or sell the same assets at the same time, a management style which is still developing, as reflected in the figures shown on page 18 for Ireland (ETFs). If we are not careful, the advent of AI could further amplify this gregarious management phenomenon.

  In general, Af2i draws attention to the consequences, in terms of rigidity, of the multiplication of rules designed to determine in advance the manager's decisions in the face of a particular event.

  Mimetic behaviour and the procyclicality that this procedure entails reduce the diversity of decisions and the possible cushioning of shocks. Paradoxically, if mimetic behaviour becomes widespread, all the funds will no longer constitute a system (in the sense of the general theory of systems) with internal damping and stabilisation mechanisms, but a single agent will emerge, which is the sum of all the funds with predictable and virtually identical behaviour, and therefore more fragile in the event of dysfunction. This is what the central bank acknowledges in the document by referring to cohorts.

Back to “Contents”

- The instability of liabilities, particularly when the investment is motivated by tax reasons that can change from one day to the next. This phenomenon is even more acute when subscribers are concentrated, and even more so when they invest in currencies other than the euro.

  This is the case for MMFs managed in Ireland and Luxembourg, which are mainly funds denominated in non-euro currencies, invested in the securities of issuers outside the eurozone and held mainly by a small number of subscribers, most of whom are non-European (see ESMA note 8 February 2023 ESMA50-165-2391 ESMA Market Report on EU MMF market).

- The construction of the product, in particular those whose trading NAV does not reflect the real value of the fund's assets. This situation applies to funds 1) where the assets held are subject to long lead times for disposal, as in the case of property funds, or funds 2) where the assets are valued using models incorporating market data but where there are only a limited number of counterparties to trade them, as in the case of derivatives, LDIs, unlisted holdings, etc. This is also the case for MMFs - the CNAVL and LVNAV formulas should be banned in the eurozone, regardless of the underlying currency.

Question 2: Do you agree with the assessment in this Discussion Paper that it is primarily the collective actions of investment funds that can generate systemic risks?

Yes and no:

Yes, if we consider collective action as a crowd movement;

No, if we refer to the scientific definition of collective action. As pointed out in the answer to question 1 about the word systemic, what are referred to in the document as collective actions by investment funds are decisions that do not result from the voluntary coordination of managers, as is the case in collective action defined from a behavioural, legal or sociological point of view.

They should therefore be referred to as mimetic actions, the sum of which puts all funds at risk, even if the trigger for these collective actions may come from a single player, causing investors and markets to distrust him.

Thus, for Af2i, the origin of these "collective actions" is once again not limited to liquidity asymmetry or excessive use of leverage but encompasses all commercial and regulatory provisions generating mimetic behaviour that amplifies the consequences of shocks or problematic situations.

On this subject, a correction: it is stated on page 39 that BNP Paribas Investment funds stopped honouring redemption requests on 9 August 2007, which is correct. However, these funds were not MMFs but bond funds.

Question 3: Do you agree that the current regulatory framework for funds - which has primarily been designed at a global level from an investor protection perspective – has not been sufficient to reduce the propensity of certain fund cohorts to amplify shocks?

Af2i believes that the assertion that the regulatory framework governing investment funds and service providers is primarily concerned with investor protection is excessive.

An investor's subscription to a fund unit involves several players: the investor, the management company, the issuers and the markets. It is clear that if investors do not have confidence in a product, particularly because they are not reassured by the regulations, the consequences will affect all these players if this loss of confidence becomes widespread.

Protecting investors also concerns and serves other players.

We must not lose sight of the fact that every investor has a choice: either to invest through a collective investment scheme, or to invest directly. For institutional investors, the choice is easy. For individual investors, the development of online transactions, whose costs are tending to be continually reduced, reinforces this alternative.

Finally, Af2i notes that, for example, in the AIFM directive, the information that must be transmitted by each management company on its positions taken on derivatives markets is primarily intended to assess potential systemic risk rather than to protect investors. The key issue then becomes the centralisation and appropriate use of this data.

All in all, for Af2i, the "amplification of shocks" by certain cohorts seems to be more the effect of the rigidity of existing rules designed to manage funds and clarify relations between managers and clients chiefly in mainly stable regimes, and not to make it possible to cope with periods of chaotic regimes.

Question 4: Do you agree with the key proposed objectives and principles of macroprudential policy for funds as set out in this Discussion Paper? Are there additional principles, which need to be considered?

While the principle of a macro prudential framework for funds may be envisaged, Af2i recalls, at least as far as European regulation is concerned, that the objective of management companies is to ensure the exclusive interest of the subscriber. The danger of any macro prudential regulation would be to give priority to this or that aspect of an authority's economic policy over the interests of the investor.

Af2i approves the concern for a balance between the costs and benefits of any macro prudential policy, as well as the desire for global coordination, which should be a general principle for all aspects relating to finance, in order to avoid any advantage for the lowest regulatory bidder, including in terms of taxation, which generates macro-economic imbalances, as has just been emphasised once again in the recent report by the European Tax Observatory.

However, Af2i draws attention to the fact that a genuine scientific cost/benefit approach (balancing costs and benefits) to setting up a system to prevent identified risks may not be feasible. This is because certain costs will be put forward in the face of benefits that are

Back to "Contents"

difficult to quantify because they are the consequences of rare and uncertain events.

Consequently, Af2i recommends that the system of macroprudential measures should include the precision and reinforcement of ex post measures (P 30 and 31) by Authorities and Central Banks.

Lastly, the notion of flexibility that would govern these macro-prudential measures must be handled with care, as the players, whoever they may be, need regulatory stability, a stability that has been called for several years but which, at least at European level, seems to be a pious hope.

Question 5: Do you agree with the analysis and the issues highlighted pertaining to the design of potential specific macroprudential tools for the funds sector? Are there are additional potential tools that could be explored?

The macro prudential tools suggested concern liquidity, leverage and interconnection, i.e. the possibility of limiting the spillover effects of funding problems to other parts of the financial system.

With regard to liquidity asymmetry, Af2i points out that, barring exceptional circumstances, this asymmetry is due to the characteristics of the markets on which the manager operates and its commitments in terms of liquidity, which are in principle set out in information documents approved by the authorities and provided to investors.

This asymmetry, if it exists, is therefore assumed by the manager. The liquidity conditions he offers investors are his sole responsibility. Liquidity policy is an essential element in investors' choice of funds and, in addition to financial management, is one of the raisons d'Ãtre of intermediated management.

The tools listed in this consultation already exist in any case in the European Union. In Af2i's view, these tools can be used provided that they are clearly set out in the information documents and used only in truly exceptional circumstances, but without necessarily having to be explained in advance, again to avoid mimetic behaviour in the event of global shocks.

Back to “Contents”

Lastly, Af2i believes that this liquidity can only be honoured on the basis of a real net asset value and not one set arbitrarily, unless a guarantee can be given effectively by a solvent third party. Otherwise, "break the buck" situations, which may be exceptional but dangerous, could have major systemic consequences.

With regard to leverage, here too it seems that the tools already exist, in particular the margin call supposed to ensure that players can honour their commitments and the limitation of leverage, the assessment of which is, it is true, different from one regulation to another. Af2i approves of the desire for global harmonisation of the level of leverage and the way it is calculated, and believes that stress tests could indeed be useful in preventing any difficult situation for a fund.

Rather than other tools, other avenues could be considered, in particular those that could help limit gregarious management, which in itself entails a systemic risk. Af2i recalls that the diversity of expectations and positions is fundamental to efficient markets and the prevention of any financial bubble. This reflection should also concern the existence of countries with lower tax standards, which are factors of imbalance and whose existence within the European Union is surprising.

Finally, we must not lose sight of the fact that many funds are likely to escape regulation altogether.

Question 6: Do you agree that tools could target the interconnectedness of funds as well as/instead of their vulnerabilities?

Interconnection or rather interdependence, as pointed out in the consultation, could indeed be the subject of a more in-depth analysis. At this stage, however, it is difficult to make proposals on the often-mechanical consequences of market failures affecting several players.

Limiting cross-shareholdings between funds or limiting a fund's investment in other funds is an initial response.

Back to “Contents”

Question 7: Do you agree with the governance and data considerations highlighted in this Discussion Paper when operationalising macroprudential policy for funds?

Af2i believes that the capital market, contrary to what is indicated in the consultation, is not intrinsically global. While there is nothing to prevent the globalisation of assets in the context of fund investments, when it comes to liabilities, it is mainly tax provisions or objectives that drive globalisation, which is often concentrated in certain markets, rather than the nature of the capital market itself.

Furthermore, while international coordination is indeed necessary, this coordination must not lead to the supremacy of one regulation over another, on the pretext of harmonisation. The episode in 2010 concerning the economics of money market funds was revealing from this point of view.

Finally, the notion of reciprocity is indeed essential. However, its effectiveness depends of course on whether or not one of the parties has an internal market. If there is no domestic market, the concept of reciprocity is irrelevant.

Af2i agrees with the principle set out in the consultation that it is not the role of regulators to interfere in the risk management of the fund industry, rightly observing that the expected interventions of central banks could encourage excessive risk-taking.

Af2i insists on the role of central banks and their interventions in the market and on the fund sector, which is merely a specific organisation of interventions in these markets by individual and institutional investors.

To the examples cited in Box B (Box B central Bank interventions in markets p 49), Af2i would add in 2008, in the United States, the rapid transformation into a Bank of certain Investment Banks in order to have access to financing from the Federal Reserve.

Back to “Contents”

With regard to data requirements, while centralisation would indeed be welcome, Af2i would like to draw attention to the following points:

- This data must be protected in terms of ownership, use and disclosure.
- the nomenclature used must be able to cover all the regulations in place and not just one of them;
- This centralisation must be carried out by an international public body, without the involvement of private institutions, in order to avoid any subsequent commercialisation of this data.

Question 8: Beyond governance and data considerations, are there additional issues that need to be considered when operationalising macroprudential policy for funds?

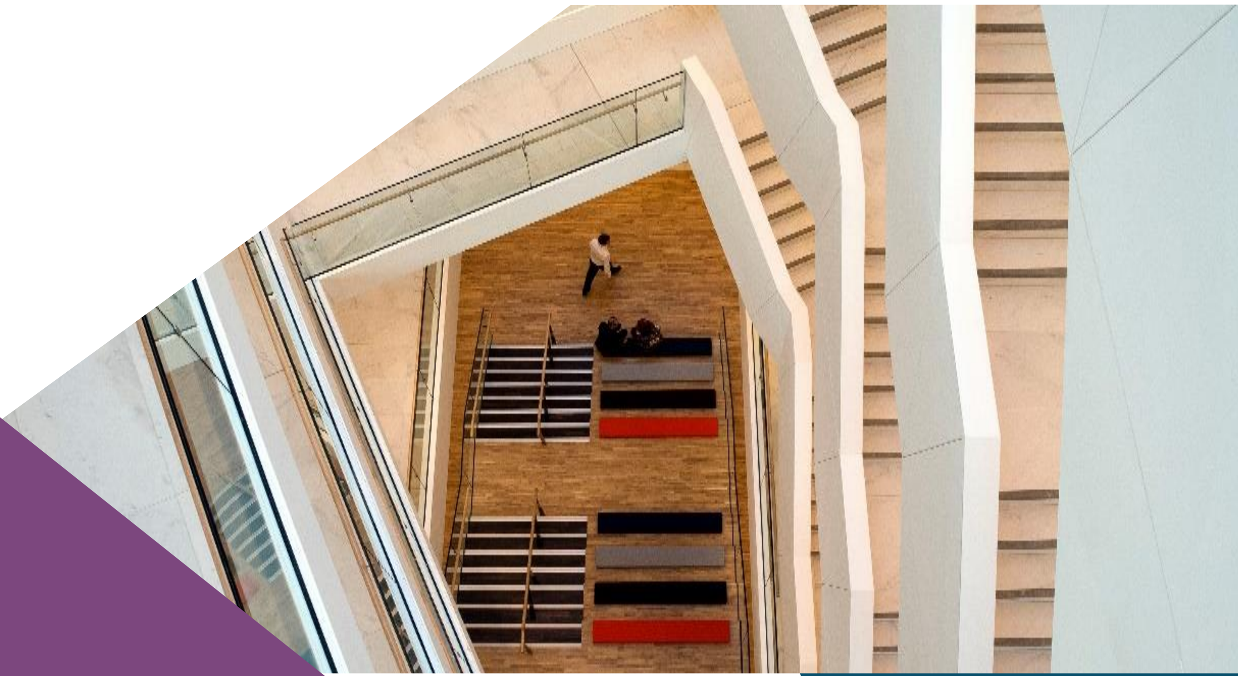
As Af2i indicated above, three points need to be taken into account:

1) Investor confidence in the fund industry is essential for the economy of this sector. Any regulation that overrides the principle currently in force, at least in Europe, of the exclusive interest of the subscriber that must be respected by the management company, for whatever reason, would have very unfavourable consequences for the fund industry. It is therefore only natural that investor protection should have been the main concern of the regulations, and this point cannot be called into question. This does not, of course, prevent asset managers from being regulated so that they can operate efficiently and, on a global level playing field.

Back to “Contents”

2) The systemic risk of the fund sector is not limited, as we have indicated, solely to the risks of uncontrolled liquidity and leverage. To these should be added any management policy or incentive that leads fund managers to act in the same direction and at the same time (mimicry and procyclicality) by promoting, for example, index management, ETFs, very attractive recommendations on investments, margin calls or maintaining minimum liquidity, as well as the potential instability of liabilities for reasons that are hexogenous to management, notably tax or concentration.

3) The draft macroprudential framework for the fund sector presented by the Central Bank responds to a concern for crisis prevention through measures implemented ex ante. However, in the analysis of organisations, even if relevant measures are likely to reduce the occurrence and consequences of a crisis, Af2i recommends above all specifying or even institutionalising ex post interventions by the European budgetary or monetary authorities (ECB).



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