

Macroprudential policy for investment funds conference

Keynote speech from Verena Ross, ESMA Chair, 20 May 2024

Ladies and Gentlemen, good morning,

It is a pleasure to be with you today, and I would like to thank the Central Bank of Ireland and Governor Makhoul for organising this event and giving me the honour of introducing the conference.

Today's event comes at the perfect moment.

- This Wednesday, the EU Commission is set to present its Consultation on the macroprudential review of non-bank financial intermediation (NBFII). Clearly, an important opportunity to look back, assess, and consider actions for the future.
- At the same time, Europe is discussing next steps on promoting EU capital markets. This topic is vital, and the urgent need to build effective capital markets in Europe can hardly be overestimated.

Both discussions show: In the EU we are preparing to take our financial markets to the next level, and today's conference is a great occasion to exchange views on the macroprudential dimension of this debate.

Important steps since the Global Financial Crisis

When looking back, 15 years ago the de Larosière Report laid the foundations of what has become the EU macroprudential framework. Drawing the lessons from the Global Financial Crisis (GFC), the high-level group recommended to establish a macroprudential framework with a clear mandate to address systemic risk. It also recommended to set up a European System of Financial Supervision, under the aegis of three new European Authorities tasked with both the application of common supervisory standards and the enhanced cooperation between national supervisors. No need to say that from my point of view, this was a groundbreaking event, giving birth to ESMA.

Of course, banking was the core financial stability concern at the time, and it doesn't come as a surprise that a mature macroprudential framework has developed first in the banking sector. But since then, attention has been increasingly shifting to the non-bank financial sector and in particular to investment funds, as these entities have grown significantly in size and influence in global financial markets.

When comparing to the financial landscape 15 years ago, the non-bank financial sector is larger and more diverse. The size of NBFIs in the EU has more than doubled since then, from 18 trillion euros of assets around the GFC to 42 trillion. The asset management sector especially has seen rapid growth: as of today, Euro area investment funds alone manage 19 trillion euros, nearly tripling in size since the GFC.

Unsurprisingly, the increasing role of investment funds in financial intermediation caught the eye of international bodies and regulators on a global and regional scale due to its systemic implications. Efforts have been focused on two areas of concern - the build-up of leverage and liquidity risk.

Leverage is not necessarily a bad thing from an investor perspective, assuming they understand the associated risks. But it can also amplify risks, not only for investors but also for the financial system as a whole, as illustrated by the recent example of funds pursuing Liability Driven Investment strategies (LDIs).

Similarly, liquidity has always been a key concern for supervisors, as it is at the core of investor protection. From a macroprudential perspective, the concerns focus particularly on "liquidity mismatches" and the risk of fire sales. The 2020 turmoil was a reminder in that context. While in the end the asset management sector was resilient, the liquidity issues that emerged in some markets and funds certainly raised a number of risk management and policy questions.

Let me first acknowledge the regulatory efforts undertaken in the past years.

- At global level, the FSB and IOSCO have been cooperating to deliver recommendations on structural vulnerabilities in asset management. This includes a framework to assess leverage-related risks and new recommendations on liquidity management in investment funds.
- In the EU, the ESRB has played an instrumental role with its recommendation on liquidity and leverage risks in investment funds, followed by policy proposals for funds investing in less liquid assets.
- Finally, the tangible outcomes of these efforts are visible in the newly revised UCITS and AIFM Directives, which introduced long-awaited provisions on the availability and

use of liquidity management tools, where we are now, at ESMA, working on the implementation.

While the ink isn't dry yet and there is still a lot of implementation work to do, we need to think about the next stage.

Macroprudential policy is a relatively modern addition to the regulatory toolkit, as it focuses on safeguarding the stability of the entire financial system rather than regulating individual institutions. For the investment fund sector, this involves identifying, monitoring, and mitigating risks that have the potential to propagate throughout the financial system, posing systemic threats.

This is why, 15 years after the de Larosière report, I see the upcoming review of the macroprudential framework from the European Commission as an important opportunity to assess where we stand on the effectiveness of the policy tools and of the supervisory framework.

We will primarily talk about investment funds today, but we need to bear in mind that the issue is broader and concerns the entire NBFIs sector, comprising investment and pension funds, insurance companies, other financial intermediaries and a range of financial activities. Systemic risk doesn't stop at regulatory boundaries. On more than one occasion, risks affecting the fund sector originated from another part of the financial sector.

Today, I would like to give you an overview of why macroprudential policy matters, but also what has been accomplished already in this space. I will then share some thoughts about the future of macroprudential policy in the EU, and the way supervisors can contribute to the debate.

Without further ado, let us first remind ourselves of the importance of financial stability in the context of recent initiatives in building effective and attractive EU Capital Markets.

A diversified EU capital market needs to consider its macroprudential policy framework

Investment funds play a significant role in financing the real economy. They provide about 2 trillion euros of the financing of EU non-financial corporations in total. In some specific sectors, they have become key investors. This is notably the case of real-estate funds, which have grown significantly in the past decade, from 400 billion euros to more than 1.3 trillion as of today. They are now the largest investors in the commercial real estate market in several EU countries.

ESMA is committed to supporting the development of EU capital markets. In fact, we are set to publish our own recommendations on how to make capital markets in the EU more effective

and attractive this Wednesday. We have developed these recommendations as ESMA, building on our collective experience as securities markets regulators and supervisors.

In the current environment with huge investment needs, Europe urgently needs more diversified funding markets, that provide long-term investment opportunities for citizens and multi-faceted funding opportunities for companies.

No doubt, boosting EU capital markets will imply also further growth of the NBFIs sector. Therefore, developing EU Capital markets will need a macroprudential framework that is up to the job. Without trust in non-bank financing, companies might not want to rely on it and savers might choose not to invest in it.

But this is also about striking the right balance: financial stability and efficient capital markets are complementary goals, but we know they can also imply trade-offs.

Risks in the investment fund sector

As highlighted in my introduction, regulators have worked in the past years to pinpoint the risks posed by investment funds, first and foremost liquidity and leverage risks.

Let me take a closer look at liquidity risk. Liquidity mismatches arise when investors can redeem in the short-term while the fund invests in assets that are not liquid, such as real estate, or in assets that can become illiquid under stress conditions, for example some high-yield bonds. When a significant number of investors rush to redeem their shares simultaneously, it can strain fund liquidity.

In such scenarios, funds may be forced to sell assets at distressed prices, exacerbating market downturns and triggering a vicious cycle of fire sales. Losses then spread to other investors exposed to the same assets, pushing them into distress too.

The 2020 market turmoil confirmed some vulnerabilities in that respect. As the markets faced a 'dash for cash', fund managers had to deal with large-scale redemption requests, leading in a number of cases to funds suspending redemptions.

The second critical aspect of systemic risk in the investment fund sector is leverage.

Leverage is a widespread practice in many investment strategies. While leverage can enhance returns in favourable market conditions, it also amplifies losses during downturns. Excessive leverage in investment funds may lead to a range of systemic knock-on effects, including heightened volatility, destabilized markets, and contagion.

Moreover, the use of leverage may amplify the effects of liquidity mismatches. One reason for this is that leveraged investment funds may need to liquidate more than one “unit” of assets to satisfy one “unit” of withdrawals. Another reason is that, when leverage is generated through repos or derivatives, the fluctuations in asset prices can increase margin calls leading funds to sell additional assets to meet their obligations.

The regulatory toolkit has been enhanced

Against the background of these risks, it is good news that in the EU we have developed tools to address liquidity and leverage risks.

Of course, investment funds differ from banks, and our macroprudential framework is tailored to their unique characteristics. It includes a mix of re-purposed micro-prudential tools and specific macroprudential tools.

Regarding liquidity risk, the recent reviews of EU key asset management regulations are set to implement the latest global standards provided by the FSB and IOSCO. Especially, UCITS, AIFMD and the EU long-term investment fund framework will make a broad set of liquidity management tools available to fund managers in normal and stressed market conditions. Compared with pre-existing tools such as suspension of redemptions, which are generally considered a last-resort measure, the inclusion of price-based tools such as swing prices will allow manager to intervene ex-ante, by imposing a cost to discourage short-term withdrawals and dampen redemption pressures during periods of stress. ESMA is currently developing the regulatory standards to implement these new rules.

From a pure macroprudential perspective, the main tool at the disposal of supervisors is the possibility to impose leverage limits, or other restrictions, under Article 25 of AIFMD. The Central bank of Ireland has been a pioneer in that respect, by imposing leverage limits on some property funds in 2022 and by imposing a yield buffer on LDI funds in 2024, in coordination with the CSSF.

The first rounds of applying Article 25 AIFMD have provided us with some important experiences. The first lesson is that, indeed, we need tools to address systemic risk. The use of leverage by LDI funds not only exposed them to liquidity and interest rate risks, but it also aggravated the market stress, with contagion to other market participants.

The other takeaway is the importance of coordination in macroprudential policy. Risks can originate in a non-EU country and affect funds domiciled or passported in several EU countries. It is therefore necessary to ensure that the same level of resilience applies to all funds across jurisdictions.

The second good news is that our capacity to analyse data and identify risks is also increasing. Over the years, regulators and supervisors have developed a monitoring framework taking into account both the risks posed by the entities and their economic functions. In the EU, ESMA is monitoring the Trends, Risks and Vulnerabilities under its remit, and we regularly publish market reports and analysis, such as detailed analysis of the risks posed by alternative investment funds and MMFs. Beyond publishing, we share detailed risk analyses with national authorities, aimed at supporting their supervisory work.

At the systemic level, the ESRB had identified non-bank risks as a key area of work at an early stage. Their Non-Bank Expert Group has been driving the EU's non-bank risk analysis for more than a decade, and just held its 50th meeting. With its NBFi Monitor, the ESRB provides the annual document of reference on non-bank market developments and potential risks to financial stability in the EU.

Looking ahead, the introduction of new UCITS data collection and the review of the reporting requirements for AIFs will improve further our ability to monitor risks within the sector.

Key issues for the macroprudential review

While we are glad to acknowledge past achievements, we should not be complacent.

First of all, because there are known limitations within the current framework, such as the challenges posed by MMFs, which are systemically relevant. Situations like the "2020 dash for cash" reveal gaps in our toolkit. The interconnectedness of the sector and the externalities it produces suggest that the flaws previously identified, such as the threshold effects of LVNAV, should be addressed. ESMA had provided in-depth analysis and policy proposals on the MMF regulatory framework, and I hope the macroprudential review can be the occasion to revisit outstanding issues.

Second, the EU Commission's macroprudential review consultation is the right time to ask how to further develop the macroprudential framework. This discussion is in full swing. Our host, the CBI, has set the scene last summer with a discussion paper on macroprudential policy for investment funds. They already have a great history in that field, notably by their active use of AIFMD macroprudential tools. Let me also mention the joint paper of the Austrian, French, Italian and Spanish financial market authorities, giving their key priorities for a macro-prudential approach to asset management.

A number of very important questions have already been identified. Let me mention just three of these questions.

1. Do we need more macroprudential tools?

European supervisors have the possibility to impose restrictions to AIFs making excessive use of leverage. But some risks are not caused by leverage, and therefore are not in the scope of this tool. For example, in some jurisdictions open-ended real estate funds may offer daily dealing and be exposed to fire sales if prompted to liquidate illiquid assets, even without exhibiting any leverage related risk. Therefore, the Article 25 power cannot be used to address risks posed by such funds.

An issue for discussion in that context could be the scope of our macroprudential tools, not only in terms of risk covered, but also their application to all type of funds, potentially even beyond AIFMD.

However, as I indicated earlier, some of the risks we want to address may also result from flaws in the current framework, and I would argue that real estate funds offering daily dealing is one example. Therefore, we need to be careful and differentiate risks that are macroprudential in nature and need to be addressed by macroprudential tools, from risks resulting from inadequate regulation or lack of proactive supervision and enforcement. Let's ensure that the macroprudential framework is not there to compensate for loopholes in the regulation and/or supervision.

2. How can we further refine our risk assessment and monitoring?

As discussed, we have come a long way in terms of data and analysis. Our possibilities are constantly growing, including additional data sets and more and more sophisticated risk indicators.

But financial markets evolve fast in terms of size and complexity. Supervision needs to adapt to the emergence of financial innovation, with the growth of certain activities raising new questions. Some entities, like sovereign wealth funds and family offices, also face similar financial risks as investment funds—such as procyclicality, the use of leverage, and large market footprints exemplified by incidents like Archegos—but such entities are not subject to the comprehensive regulatory oversight that applies to funds.

Staying on top of market developments and risks is essential for macroprudential policy. I believe it is worthwhile considering therefore whether our risk analytical work and stress testing routines need an additional boost. This includes using data to identify and measure interconnectedness between NBFIs and the banking sector.

3. How can we further enhance cooperation on macroprudential policies?

A macroprudential framework should facilitate coordinated responses to crises, thereby addressing externalities that affect financial stability in the broadest sense.

The merits of close cooperation become particularly visible in our work on the EU investment fund industry, where the fund, the asset management company and final investors are often domiciled in different jurisdictions across the EU. In the case of LDI funds for example, there was strong cooperation between the CBI and the CSSF since the November 2022 stress. This is important.

At EU level, ESMA has played its role of coordinator: NCAs reported their assessment of the risks posed by LDI funds and, when we were notified of the Article 25 measures, we assessed their relevance and issued our ESMA advice.

Our existing processes and routines for cooperation are already an important asset. But it occurs to me that we cannot have enough of such exchanges, and that it is worthwhile exploring ways of further intensifying our cooperation. And I am thinking of cross-sectoral as well as cross-border cooperation, and across our activities of risk assessment, stress testing, policy formulation and application, and supervision and enforcement.

Conclusion

Let me conclude.

Macroprudential policy “beyond banking” has been a long-standing topic. Looking back at what has been achieved in the past 15 years, we’ve been already doing a lot, particularly when it comes to investment funds.

In the EU, the revised fund regulations are introducing long-awaited provisions on liquidity management tools, as well as meeting a perennial request to introduce a UCITS reporting regime.

I was glad to leave you with a few thoughts from ESMA’s perspective this morning. Doing so here at the Central Bank of Ireland, which has played a great role in developing macroprudential policy in the fund sector, is a particular honour.

Building a sound macroprudential framework remains a topical and important issue. This is both a complement and a pre-requisite to the development of effective capital markets with diverse funding sources.

Now that the consultation for the macroprudential review is about to start, I have left you with more questions than answers but I hope this will assist in stimulating today’s discussion. There is probably no single or simple solution, but not to ask the questions or not to be ambitious in finding the answers would be a missed opportunity in my view.

I wish you an interesting day here in Dublin. Thank you.