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RE: Discussion Paper: An Approach to Macroprudential Policy for Investment Funds

BlackRock¹ is pleased to have the opportunity to respond to the Discussion Paper on an approach to macroprudential policy for investment funds, issued by the Central Bank of Ireland.

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to comment on the issues raised by this Discussion Paper and will continue to contribute to the thinking of the Central Bank of Ireland on any issues that may assist in the final outcome.

We welcome further discussion on any of the points that we have raised.

Yours faithfully,

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¹ BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

Executive Summary

We welcome the constructive discussion the CBI is looking to open through this Discussion Paper. We support all efforts to improve the resilience of the investment funds sector. We have long advocated for policies that enhance funds' liquidity risk management, promote sensible use of leverage, and improve overall market functioning.

We share the CBI's objectives of ensuring funds are resilient and do not 'amplify shocks'. We believe a macroprudential perspective can enhance the use and application of existing fund-level (or micro-prudential) tools, and thereby enhance the resilience of the funds sector. Any discussion about policies developed for the funds sector with a view to enhancing financial stability should be informed by a few fundamental observations, made from a system-wide, macroprudential perspective, which we have outlined below.

First, that there are a wide range of end-investors in markets. Some engage asset managers to manage money on their behalf, others invest directly. The share of global financial assets overseen by asset managers is less than a third. Open-ended funds are a subset within these assets: for example, available data shows that open-ended bond funds account for a small part of fixed income markets. See Annex 1.

Second, that the funds sector is highly heterogeneous. Within the Discussion Paper, the CBI refers to open-ended bond funds, money market funds, exchange-traded funds, real estate funds, liability-driven investment funds, and hedge funds. Each of these strategies vary significantly in their dealing structure, asset class, investment strategy and use of leverage.

Third, that funds are one among many participants in financial markets. Prevailing market dynamics are a product of all market participants – encompassing the full range of end-investors, intermediaries, product types, and market infrastructures. Market-wide outcomes cannot be delivered by focusing on individual entities or product types in isolation.

That said, it is prudent for policymakers to ask whether certain investment funds have features which could cause undue or disproportionate pressure on markets. Liquidity mismatch and leverage are two of the main 'channels' identified by the CBI for funds to amplify volatility. These risks can exist in all types of investment vehicles and are not unique to investment funds but do warrant further discussion.

Managing liquidity risk is central to managing open-ended funds. Daily dealing funds invested in assets that trade intraday can face a first-mover advantage within the fund if fund investors are incentivised to transact ahead of others and avoid paying increased liquidity costs. Anti-dilution tools such as swing pricing mitigate this by ensuring those costs are borne directly by the transacting investors.

Liquidity mismatch only arises where investment fund dealing terms do not reflect how frequently underlying securities are traded; fund structures should be tailored to reflect tradability of underlying assets. Liquidity mismatch does not exist for open-ended daily dealing funds invested in securities that trade intraday, for example.

In the EU, the UCITS Directive and AIFMD ensure that fund dealing terms align with their asset liquidity and facilitate the use of anti-dilution tools by fund managers. However, there is more that can be done to enhance application of liquidity

management tools (LMTs) across the board, and we welcome recent proposals from the FSB and IOSCO, as well as recently agreed changes to AIFMD and the UCITS Directive which aim to do so.

Leverage, if not properly managed, can also pose a vulnerability that when acted upon by a shock, impacts on markets more broadly as investors sell assets to meet margin calls or to deleverage. At the same time, leverage can be a useful tool for investors – for example to hedge risks or to match liabilities. It is important that policymakers can make an informed assessment of how leverage is used relative to the underlying investment strategy, and act to mitigate any specific risks.

In the EU, the UCITS Directive and AIFMD have put in place measures for policymakers to monitor and manage leverage in the funds sector. Both frameworks require investment funds to report their leverage: UCITS funds' leverage is restricted, while AIFMD gives national authorities powers to limit leverage in AIFs – which the CBI has used recently for real estate funds. Again, there is more that can be done to improve transparency around leverage, and we welcome international-level efforts by the FSB and IOSCO to improve consistency and comparability of leverage reporting.

When considering development of policies for the funds sector beyond those currently in place, we believe it is important to be very clear about the objectives, and to design policies accordingly. Our understanding from the Discussion Paper is that the CBI's stated aim is to mitigate any potential systemic risks stemming from the funds sector, and to meet that aim by mitigating any potential sources of 'amplification'.

Systemic risk is defined by the CBI as "disruption to the provision of financial services caused by an impairment of all, or parts, of the financial system, with serious negative consequences for the real economy". This should be clearly distinguished from price volatility, which is part of normal market functioning – and we share the CBI's view that **policies for the funds sector should not and cannot aim to target asset prices.**

This distinction is important to keep in mind when considering the means by which the CBI proposes to deliver on its objective, i.e., by developing policies that prevent 'cohorts of funds' from 'amplifying adverse shocks'. Where there is a risk that particular types of investment funds could place undue or disproportionate pressure on markets, policymakers are right to intervene and ensure the funds in question have appropriate safeguards in place. **However, preventing 'amplification' should not be equated with policies that place restrictions on funds' ability to invest and trade on equal terms with other market participants.**

We agree with the CBI that simple replication of policies designed for banks in the funds sector is likely to be counterproductive. Macroprudential tools were originally conceived as a means of preventing systemic risk originating from the banking sector by imposing minimum capital and liquidity requirements on banks. Banks by design engage in maturity and liquidity transformation and are characterised by high levels of leverage. In the Global Financial Crisis (GFC) solvency and liquidity issues emerged that caused or risked causing bank failures.

The macroprudential framework for banks put in place post-GFC was applied relatively uniformly across the banking sector. That uniformity reflects the fact that while each individual bank might vary in size, commercial focus, or geography, their fundamental structural features and business models are more or less homogenous.

By contrast, the funds sector is – as noted – highly heterogeneous, with structures that differ fundamentally to banks. Investors in funds bear all investment risks and absorb all losses. However, we recognise the CBI's concern that activities in the funds sector should not unduly 'amplify' market movements and that policymakers wish to consider how funds and other market participants interact. It is legitimate for policymakers to look to enhance resilience and mitigate risks from the funds sector, but any policy must consider what the specific risks are, how they are generated, and how to mitigate them. **There cannot be a one-size-fits-all approach to regulating the funds sector.**

We agree with the CBI that many of the potential macroprudential tools mentioned in the Discussion Paper risk being discriminatory, ineffective, and counterproductive. Some will create incentives for investors to 'run' which currently do not exist; while others will simply incentivise investors to hold the same assets in unregulated vehicles and products outside of the scope of the proposed tools, which would give regulators less oversight and control. The reason for this, in our view, is that many of the proposed tools represent a form of restriction or obligation on funds that does not exist for direct holders of the underlying assets, thereby overriding fund investor interests. Indeed, we believe that any policies that undermine investor protection are in turn likely to undermine financial stability. Investor protection and financial stability should, therefore, be viewed as complementary objectives and indeed investor protection is a pre-condition for effective management of risks to financial stability.

Similarly, activation of fund-level tools by regulators on financial stability grounds will by definition only impact a subset of investors in a given asset class. It is therefore more likely that any such intervention will be ineffective or unfair (by disadvantaging fund investors versus direct or separate account investors) and could be harmful or counterproductive (by signalling to other investors holding related assets directly that there is a problem in the market, prompting them to exit – potentially exacerbating the original problem).

In our view, all of these considerations point to the need for a products and activities-based approach to improving resilience in the funds sector, enhanced by a system-wide macroprudential perspective based on comprehensive data on the funds sector, and on the wider financial ecosystem in which it is situated.

A financial stability reform programme aiming to deliver greater market-wide resilience should take into account the activities of all end-investors, consider the critical role of intermediaries and market structure, and seek to improve transparency across the board to develop a comprehensive picture of market activity and to understand how all market participants interact.

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

Before drawing conclusions about whether investment funds can generate systemic risk, we believe it is important to i) determine the extent to which vulnerabilities exist in investment funds; and ii) make a distinction between systemic risk and price volatility in markets.

We agree that liquidity mismatch and leverage are risks that, if not properly managed, could have an impact on markets more broadly as market participants sell assets to meet liquidity demand or to deleverage. However, these risks can exist in all types of investment vehicle and are not unique to investment funds. It is important to recognise the fact that investment funds are minority investors in most markets. Asset managers account for less than a third of global financial assets, and open-ended funds are a subset of the assets that they manage. See Annex 1.

We note that the CBI's main concern is to prevent any "amplification" of shocks by investment funds. While we believe there is a critical difference between price volatility caused by trading and systemic risk, there is a legitimate question to ask about investment funds – namely, whether they have features which may place undue or disproportionate pressure on markets. We discuss the channels identified by the CBI in turn below.

Liquidity mismatch

Liquidity mismatch arises when investment fund dealing terms do not reflect how frequently traded the securities they hold are, e.g., when funds are invested in inherently illiquid assets, offer daily dealing, and/or do not integrate notice periods, appropriate redemption windows, or other quantity-based tools. The liquidity profile of a fund's assets should be considered at the design phase and the fund should be structured to avoid scenarios where assets cannot be sold in time to meet investor redemptions.

There is no liquidity mismatch if open-ended daily dealing funds are invested in securities that trade intraday: as the assets trade continuously, redemptions can always be met. Investors hold an equity stake in the fund, which fluctuates in value in line with underlying assets. However, assets traded intraday can still see significant changes in the cost of accessing liquidity. If these costs are not passed on to investors transacting in or out of a fund, a 'first-mover advantage' may arise whereby investors are motivated to transact ahead of others to gain a better price, negatively impacting or 'diluting' the positions of the remaining investors. This kind of first-mover advantage *within funds* can therefore introduce risk, but it is important to differentiate it from first-mover advantage *in markets*.

First mover advantage *within funds* should be mitigated with increased use of anti-dilution tools that ensure transacting investors pay the cost of liquidity. First mover advantage *in markets* – that is, the ability for market participants to trade first or utilise available market liquidity ahead of other market participants – will continue to exist irrespective of investment vehicle, whether direct investments, investments via separate accounts, or investment funds.

We believe this is a critical distinction. The goal of policymakers should be to further reduce any incentives created by the fund structure for some fund investors to transact in advance of other fund investors and ensure a level playing field between investors in funds and investors holding assets directly. However, policy should not be used to change strategic allocation decisions by investors responding to market conditions or individual investment requirements. Put differently, policies should target first mover advantage *within funds*, but not first-mover advantage *in markets*.

Leverage

If not properly managed, leverage can create a vulnerability that, when acted upon by a shock, can generate impacts on markets more broadly as investors are required to sell assets to meet margin calls or to deleverage.

The use of leverage is not unique to investment funds, but funds' use of leverage is subject to regulation and transparency. In the EU, the UCITS Directive and AIFMD require funds to disclose their leverage, and either restrict the total leverage funds are permitted to take ex-ante (in the case of UCITS) or give regulators the power to do so (in the case of AIFMD).

Fund managers have a fiduciary duty to manage leverage in accordance with each fund's investment mandate, and to mitigate any of the associated risks – for example the liquidity risk of potential margin calls. This is often reinforced by regulation – for example ESMA's liquidity stress testing guidelines, which require managers to ensure they are prepared to meet liquidity demand from margin calls, as well as redemptions.

Similarly, it is worth mentioning that for all financial market participants, whether levered by using cleared or bilateral derivatives, there are requirements to post initial margin, which naturally limits leverage. Requirements to post margin is not unique to investment funds.

Interconnectedness

The CBI suggests three main interconnectedness risks stemming from the funds sector: i) the propensity to 'excessively' reduce the supply of credit during periods of stress; ii) funds' counterparty relationships with other parts of the financial sector; and iii) exposure to 'sector-wide fire sales' and falling collateral prices.

When considering each of these risks, it is again important to draw a clear distinction between systemic risk and price volatility. Policymakers should consider whether risks identified are unique to certain investment fund types, or are present in all investment vehicles; and whether price volatility reflects the actions of particular market participants or market-wide structural issues.

Firstly, it is not clear what would constitute an 'excessive' withdrawal of credit, and where the boundary lies between what policymakers consider an 'impairment' of financial services and changes in the supply or pricing of credit that are ordinary parts of market functioning. Data on Euro-denominated corporate bond issuance since 2017 does not indicate that markets withheld financing to the non-financial sector in any period covered, including during 2020. See Annex 3. The Discussion Paper also cites redemptions from Money Market Funds (MMFs) during March 2020 as an example of credit being withdrawn. However, it is not clear that redemptions from

MMFs had a transmission effect into underlying markets or were a driver of underlying market dysfunction. In our experience, the underlying market dysfunction was a significant complicating factor that MMFs needed to manage on top of the investor redemptions that were taking place at the time. Demand for liquidity at a system-wide level spiked as end-investors looked to build their cash reserves and were required to meet margin and collateral calls that in turn increased significantly as market volatility rose. At the same time, the structure of the underlying short-term funding markets was in need of modernisation to increase intermediation capacity.

Secondly, while investment funds – particularly those that are levered – can clearly pose a counterparty risk to the entity providing their finance, this risk is not unique to funds. Counterparty risk, or the risk of default, is inherent in the extension of credit from one party to another, and how that risk is managed and priced is an integral part of all market participants' activities. That said, there is a legitimate question as to whether market participants, particularly those that extend credit, have all the information needed to price risk accurately. Regulated investment funds are required to report their leverage and disclose their portfolio composition, but funds are only one type of investment vehicle, and many others are not subject to the same level of transparency.

Finally, investment funds' trading – like that of any other vehicle – will influence market dynamics and impact asset or collateral prices. The question is the extent to which this influence is disproportionate or unique versus other types of investment vehicle. We agree with the CBI that the presence of high leverage or liquidity mismatch could represent a vulnerability. However, this risk is not unique to investment funds, and we believe it is important to keep in mind the considerations outlined above as to what constitutes liquidity mismatch, and how leverage is already regulated and managed in the investment funds sector.

We recognise that financial markets as a whole are prone to bouts of liquidity stress arising when market volatility spikes. As the CBI recognises, policy reforms following the global financial crisis addressed credit counterparty risks and strengthened bank balance sheets but have resulted in more frequent bouts of liquidity stress. The move to central clearing and collateralisation of risk (e.g., via variation margin) has also hard-wired an increase in the demand for cash when volatility spikes during stressed periods into the financial system. At the same time, changes to bank capital and liquidity rules have reduced their ability to hold risk and move cash through the system. This structural tension leads to more frequent liquidity stresses in financial markets, and is illustrative of the way in which all parts of the financial system are interconnected.

We believe there are policies that could be explored that could help ease system-wide liquidity stress. Policymakers could consider how bank capital regulations impact repo market capacity, and in turn liquidity supply; improvements to underlying market structure for commercial paper and bond markets; and eligible collateral requirements for central counter parties (CCPs) – specifically, concentration limits for certain security types, and the ability to pledge money market fund shares as collateral.

In sum, while there are legitimate risks in investment funds that policymakers should seek to address, it is important to recognise that they are not unique to investment funds, that investment funds are only a subset of market participants, and that investment funds are highly heterogenous. Liquidity mismatch and leverage if not properly managed in any part of the financial system can pose risks to financial stability. Funds can influence market dynamics, and pose counterparty risks, but so too

can all other types of market participants. We do not believe that narrowly targeting investment funds for macroprudential regulation would have a material impact on overall financial stability in adverse market conditions. Instead, we encourage policymakers to take a system-wide macroprudential perspective, identify risks associated with specific products and activities, and tailor regulation accordingly.

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?

The CBI suggests that while funds may be individually stable and resilient, their collective actions may create imbalances within the financial system and make the sector vulnerable to negative shocks, particularly in times of stress. It is important, however, to make a clear distinction between the ‘collective action of investment funds’, overall market dynamics, and a level of price volatility that the CBI would deem to be systemically risky.

The collective actions of any group of investors will influence market dynamics. Whether investment funds have a unique and/or disproportionate impact on markets is, in our view, a separate question. Market dynamics are influenced by funds, but also by the range of other end-investors in markets.

For example, analysis by the CBI shows that Irish-resident LDI funds accounted for 30% of net Gilt sales by LDI funds during the Gilt market crisis in 2022.² We understand that there are some small LDI funds domiciled in Luxembourg, and – at the time of the Gilt crisis – none in the UK. It could, therefore, be inferred that the remaining 70% of net sales were made directly by asset owners. Similarly, the SEC’s analysis of US bond markets in March 2020 concluded that “US bond mutual funds experienced \$255 billion of net outflows during March 2020, with another \$21 billion from bond ETFs. However, total trading volume in the corporate bond market during the same period was more than triple the level of bond fund outflows, totalling \$1.08 trillion in March 2020”.³

The Discussion Paper refers to several recent examples where the CBI believes a shock or trigger event was amplified by the collective behaviour of ‘fund cohorts’ and the interplay between their underlying vulnerabilities and interconnectedness. We believe it is more precise to describe the examples given as risks specific to certain *products and activities* in the market-based finance sector. This has important implications for the type of regulation that is appropriate – discussed further in Q.3.

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?

We agree that the currently regulatory framework for investment funds has been primarily designed from an investor protection perspective. However, this should not in itself be a reason to think it is less effective for mitigating financial stability risks. Indeed, we believe investor protection and financial stability are not just

² See Central Bank of Ireland [Financial Stability Notes, Vol. 2023, No. 7: Irish-Resident LDI Funds and the 2022 Gilt Market Crisis](#).

³ US Securities and Exchange Commission, Division of Economic and Risk Analysis, [US Credit Markets: Interconnectedness and the Effects of the COVID-19 Economic Shock](#), October 2020. See page 38.

complementary objectives, but rather that investor protection is a necessary pre-condition for financial stability. Given the CBI's stated objectives, we believe the more important consideration should be whether regulation mitigates any potential 'amplification' of shocks.

The two main amplification mechanisms identified by the CBI are liquidity mismatch and leverage. While the regulatory framework has been designed from an investor protection perspective, it nevertheless contains provisions that aim to prevent liquidity mismatch, ensure liquidity risk management processes are in place, and allow policymakers to monitor and limit leverage.

In the EU, for example, the UCITS Directive contains provisions on eligible investments designed to ensure ongoing liquidity and to limit the holding of illiquid assets in fund structures intended to offer daily liquidity. More recently, this has been complemented by ESMA liquidity stress testing guidelines for UCITS and AIF managers. The latest review of the UCITS Directive and AIFMD also means managers will be required to utilise the full liquidity management toolkit, including – crucially – anti-dilution tools that mitigate first-mover advantage in funds.

That said, there is room to further enhance fund liquidity risk management. We welcome the recent FSB and IOSCO proposals to ensure that fund dealing terms reflect underlying assets and to raise the bar for adoption and use of anti-dilution tools globally. We support the principle set out by the FSB that funds mostly invested in 'liquid' assets should be able to offer daily dealing, and those with significant investments in assets defined by the FSB as 'less-liquid' should continue to offer daily dealing provided they can incorporate at least one appropriate anti-dilution tool.⁴ Regulators can further support more widespread use of anti-dilution tools by ensuring that investment managers are operationally prepared to deploy those tools and have appropriate contingency plans in place for managing extraordinary market conditions. As such, we welcome the focus in the recently agreed changes to the UCITS Directive and AIFMD on enhancing the use of liquidity management tools across the EU.

Similarly, under the UCITS Directive, funds must comply with strict leverage limits. UCITS are further limited by the amount they can borrow with a limit of up to 10% of their assets on a temporary basis. AIFMD does not set any hard limits, but managers must report the leverage in their funds. AIFMD also grants national authorities the power to impose limits on the leverage employed by an AIFM under its jurisdiction under Article 25, a power which has been used by the Central Bank in relation to Irish domiciled real estate funds.

That said, it is reasonable that policymakers would like a clearer and more consistent picture of leverage across the financial system, and we support further work in this area. Measurement of leverage is not straightforward, and the level of risk is highly dependent on the underlying investment strategy. A new workstream on non-bank

⁴ In its [recent consultation](#) on liquidity management in open-ended funds, the FSB defines liquid assets as those that are "readily convertible into cash without significant market impact in both normal and stressed market conditions". The FSB defines less liquid assets as "those assets whose liquidity is contingent on market conditions, but they would generally be readily convertible into cash without significant market impact in normal market conditions. In stressed market conditions they might not be readily convertible into cash without significant discounts and their valuations might become more difficult to assess with certainty."

leverage has been added to the FSB's NBFIs work program for 2024 onwards, which aims to address concerns about lack of data and transparency on leverage.

In sum, the current regulatory framework for funds in our view provides the right set of tools for fund managers and regulators to monitor and mitigate risks. But as discussed under Q.2, we believe it is more useful to think about risks stemming from particular *products and activities* than from 'certain fund cohorts'. The funds sector is highly heterogeneous, and it is important to be specific about what the risks are, how they are generated, and how to mitigate them. There is not and cannot be a one-size-fits-all approach to regulating the funds sector.

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?

We believe a system-wide, macroprudential perspective can enhance the use and application of existing fund-level tools, and thereby enhance the resilience of the funds sector. A financial stability reform programme aiming to deliver greater market-wide resilience should take into account the activities of all end-investors, consider the critical role of intermediaries and market structure, and seek to improve transparency across the board. This will allow policymakers to develop a comprehensive picture of market activity and to understand how all market participants interact. In terms of specific interventions, we believe there are two important points to keep in mind.

Firstly, that to date the use of macroprudential tools has focused on the mitigation of systemic risks arising from the banking sector. Banks by design engage in maturity and liquidity transformation and are characterised by high levels of leverage. In the Global Financial Crisis, solvency and liquidity issues caused banks to fail, or to be at risk of failing. A bank failure would represent disruption to critical financial services, for example the operation of the payments system. Interconnections between banks during the GFC also meant that the failure or risk of failure at one bank quickly translated to the failure or risk of failure at another, threatening similar consequences for critical financial services.

Put differently, systemic risk – defined by the CBI as “disruption to the provision of financial services caused by an impairment of all, or parts, of the financial system, with serious negative consequences for the real economy” – materialised. The macroprudential framework for banks put in place post-GFC was comprised mainly of minimum capital and liquidity buffers – applied more or less uniformly across the banking sector. This uniformity reflected the fact that while each individual bank might vary in size, commercial focus, or geography, their structural features and business models are fundamentally the same.

Secondly, the CBI rightly points out that macroprudential policy in general encourages a system-wide perspective. It has also said that the aim of a macroprudential framework for funds would look to make the sector 'more resilient to stress and less likely to amplify shocks'; while noting that any framework should not aim to target asset prices, should not simply replicate or extend the bank macroprudential framework to funds, and should target 'cohorts of funds'.

Keeping these two points in mind, we believe that the objectives, principles, and general parameters set out by the Discussion Paper may not be consistent with the development of what would commonly be understood as a macroprudential framework: that is, the application of capital and liquidity buffers designed for a

homogenous bank business model cannot and should not be extended to a highly heterogenous non-bank or funds sector. Focusing regulation on 'cohorts of funds' to avoid 'amplification' of shocks in a way that does not look to target asset prices, in our view, speaks to the need for a regulatory framework that focuses on specific products and activities, takes a system-wide macroprudential perspective, and regulates in a way that recognises the different risks arising from a highly heterogenous sector.

We share the CBI's objectives of ensuring resilience of funds, and that funds do not 'amplify shocks'. However, we believe these objectives can be achieved by enhancing the application of existing fund-level tools, rather than application of macroprudential tools, as they are traditionally understood to the funds sector. Indeed, many of the potential macroprudential interventions proposed by the CBI in the Discussion Paper are, we believe, variations on the existing set of fund-level regulations and liquidity management tools.

However, primary responsibility for activating fund-level tools should remain with fund managers. While in a small number of cases regulation permits competent authorities to direct managers to activate tools on investor protection grounds⁵, asset managers and fund boards will typically have the most detailed and up-to-date information and experience of their funds, market conditions, and investor behaviour. Decisions to activate tools are often highly time-sensitive and dependent on evolving market conditions, and in all but the most exceptional circumstances, asset managers are best placed to decide how and when to deploy LMTs.

Activation of fund-level tools by regulators on financial stability grounds will by definition only impact a subset of investors in a given asset class. It is therefore more likely that any such intervention will be ineffective or unfair (by disadvantaging fund investors versus direct or separate account investors) and could be harmful or counterproductive (by signalling to other investors holding related assets directly that there is a problem in the market, prompting them to exit – potentially exacerbating the original problem).

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 any additional potential tools that could be explored?

Any regulation of the sector must consider the fundamental differences between banks, non-banks, and indeed significant differences between types of non-banks. For reasons outlined above, we believe that the application of macroprudential tools proposed in the Discussion Paper to the funds sector are likely to be discriminatory, ineffective, or counter-productive. We consider the proposals raised further below.

A more prescriptive regulatory framework governing the use of price based LMTs, covering swing factors and thresholds

We support efforts by the FSB and IOSCO to enhance the use of price based LMTs and agree there is more that can be done to improve uptake and use of anti-dilution tools. We believe that developing best practices is the most appropriate approach to enhancing the use of anti-dilution tools, and strongly discourage any intervention that aims to prescribe particular models or impose minimum costs on investors. For the

⁵ For example, the UK Financial Conduct Authority specifies that UK open-ended funds investing in inherently illiquid assets, such as real estate, must suspend dealing if there is 'material uncertainty' about the value of any asset(s) representing 20% or more of the fund portfolio.

purposes of this discussion we focus on swing pricing, which is the most commonly used anti-dilution tool for EU-domiciled funds.

Swing pricing or other anti-dilution processes must be tailored to a fund's portfolio and investor base. Given the immense variety in the range of open-ended funds available and the variety in the size and organisation of asset managers, we do not believe it is practical or desirable to pursue a prescribed approach. Local fund supervisors and its oversight entity are best placed to ensure that these best practices are available, ensuring managers have appropriate oversight and governance in place.

We strongly discourage regulatory intervention in setting specific swing factors with a view to managing fund flows or market dynamics. Determining and applying swing factors requires judgment and expertise from a range of asset management functions and is dependent on market conditions and individual fund flows – it cannot and should not be a prescribed process. Swing pricing is first and foremost an investor protection tool, and swing factors are set primarily to ensure remaining investors do not bear the explicit or implicit costs of transacting investors.

Any deviation from this, for example by requiring the application of a punitive swing factor during stressed episodes, would be detrimental to investors using open-ended funds. Any significant departure from a fair estimate of the transaction costs of meeting net capital flows runs the risk of constituting a pricing error which securities regulation may require transacting investors to be compensated for. Indeed, existing regulation of swing pricing stipulates that it is to be used solely to reduce dilution of fund investors, based on the cost incurred or expected to be incurred for a transaction, and cannot be used to create a 'profit' or a 'loss' for fund investors. The corollary of this is that a fund should not deliberately inflate or reduce a swing factor to influence investor behaviour.

Moreover, imposing swing factors that are deliberately in excess of actual liquidity costs would create an unlevel playing field between open-ended fund investors and investors holding assets directly. It would put one class of investors at a disadvantage compared to others by constraining their ability to take advantage of market opportunities. In practice, this is likely to constrain retail investors' access to markets, disadvantaging them relative to institutional investors with a larger range of investment vehicles to choose from.

Instead, we encourage regulators to facilitate improved access to information and resources that will ultimately improve swing pricing decisions, by improving fund managers' ability to account for the behaviour of other market participants. The recent proposed guidance from the FSB and IOSCO on open-ended funds liquidity risk management emphasises the incorporation of market impact into the calibration of anti-dilution tools.

Accurate estimates of market impact are highly dependent on data availability. For example, data on trading activity is one of the most valuable inputs for setting swing factors appropriately. While transparency has significantly increased in recent years, there is still room for improvement in many jurisdictions. We encourage the development of consolidated tapes for equities and fixed income across all markets. This will provide a comprehensive and authoritative overview of market activity in real-time, in turn allowing improved assessments of market depth and transaction costs, especially during periods of market volatility.

Access to more granular data on end-investor types would also be beneficial. For funds intermediated by distribution networks, modelling investor behaviour can be limited by

the aggregation of transaction requests via nominee or omnibus accounts. Policymakers should improve the flow of critical information on the types of investors transacting in omnibus accounts, the size and concentration of investor holdings and industry-wide data on historical worst-case redemptions. This would inform better manager assessments of potential redemption patterns by investor type, differentiating between transactions arising from wealth management or asset allocator platforms on the one hand, and investors in tax-incentivised savings accounts on the other.

Wider use of notice periods for certain less-liquid funds, including via more prescriptive regulatory requirements

Open-ended funds (OEFs) do not face bank-like run risk. Bank depositors represent a debt obligation for the bank, their principal must be returned at par, and bank runs can occur when depositors demand their money bank in short order. By contrast, OEF investors have an equity stake valued according to their pro-rata share of underlying fund assets and bear all investment risks. Redemptions are generally met by selling a representative sample of fund assets, rather than relying on cash or near-cash assets.

OEFs therefore face redemption risk, that is, the risk of difficulty in meeting investor requests to redeem shares for cash within the timeframe required without negatively impacting remaining shareholders. These risks are considered at the fund design and portfolio construction stages, as well as on an ongoing basis (see Annex 2).

OEFs are designed to ensure that their dealing and pricing terms are consistent with the assets they invest in. Some assets – like real estate or private debt – are inherently illiquid and cannot be traded at short notice. At the other end of the spectrum, large-cap equities and sovereign bonds like US Treasuries trade frequently at high volumes intraday on all trading days. Within this spectrum, some assets – like asset-backed securities – trade frequently but have unique market structures that require special consideration; while others – such as High Yield or Emerging Market bonds – trade frequently but with variable liquidity cost.

Judgements about how to structure funds – including the use of notice periods – must therefore be informed by observations of trading volume as well as trading costs.

OEFs investing substantially in inherently illiquid assets present a liquidity mismatch if daily dealing is offered – this covers assets that do not trade frequently and are not on public markets, such as real estate, infrastructure, or other private assets. OEFs substantially invested in these assets should not offer daily dealing and should integrate notice periods that are appropriate to the underlying market.

Some securities – for example certain types of asset-backed securities – might trade frequently but require more upfront preparation to do so. OEFs invested in these assets may be able to offer investors redemptions every day but make use of notice periods to allow fund managers to prepare trade orders.

For OEFs invested in public securities that trade on an intraday basis (such as corporate bonds) there is no liquidity mismatch (as the assets are priced and traded continuously) and daily dealing is suitable since it matches the underlying market.

Extended notice periods are appropriate for funds investing substantially in inherently illiquid assets with regular liquidity windows, such as real estate or specialised alternative strategies. We do not believe extended notice periods should be required for

open-ended funds invested in public securities that trade on an intraday basis. This would disadvantage their fund investors vis-à-vis investors holding assets on their own account or through other investment vehicles. Institutional investors would likely migrate assets out of funds and into other structures, disadvantaging retail investors without that option.

Calibrating liquid asset buffers for specific fund cohorts

The CBI notes that “unless accompanied by vertical slicing and an appropriate method for allocating costs of redemptions to redeeming investors”, mandatory liquidity buffers may “increase incentives for investors to redeem early during signs of financial market stress, as investors may fear that remaining in the fund could leave them with less liquid assets if the liquid asset buffer is exhausted.” We agree: mandatory liquidity buffers for funds in our view would be discriminatory, counter-productive, and ineffective.

They would be discriminatory both between investors within a fund and between investors using other investment vehicles. Relying on liquidity buffers to meet redemptions undermines investor protection by negating the principle of equal treatment of investors: some investors will have their assets met in cash, leaving other investors with a more concentrated portfolio. They would also disadvantage investors in funds relative to those who are able to hold assets directly who would not be required to hold the same levels of cash in their portfolios, impacting their investment returns.

They would be counter-productive, because investors who ‘move first’ would not bear any liquidity risks, at the cost of remaining investors. This would create a strong first mover advantage within a fund - creating incentives to ‘run’ that do not otherwise exist - and in turn the type of amplification effect the CBI is seeking to avoid.

They would be ineffective because the heterogeneity of funds means that the appropriate amount of cash or liquid assets would need to differ significantly from fund to fund. In the event of significant redemptions, a liquidity buffer would likely be inadequate to meet redemptions. Relying solely on liquidity buffers to meet redemptions means the portfolio would become more concentrated in less liquid assets with each round of redemptions.

More granular requirements in the context of stress testing, including taking into account the actions of other market participants

We believe that actions of other market participants are, to an extent, already taken into consideration during stress testing exercises using a number of proxies.

Margin calls are a possible source of liquidity demands on funds and are routinely considered as part of ongoing liquidity risk management. Fund managers stress test their funds for their ability to meet margin calls in a range of different scenarios. This is reflected in many existing regulations – for example the ESMA liquidity stress testing guidelines for UCITS and AIFs. We discuss some of the limitations fund managers face in modelling margin calls under Q.6.

As well as margin calls, stress tests consider the redemptions a fund might face in a wide range of scenarios, and how the liquidity of fund assets might change in a range of scenarios e.g., increasing liquidity costs during stressed market conditions. Modelling increases in liquidity cost does, to an extent, represent taking other market participants’ actions into account.

Another way fund managers can consider the actions of other market participants in their stress testing regimes is by modelling those participants' actions in the stress test itself. However, the sophistication of modelling of this kind is completely dependent on the degree of data availability, which is often incomplete or does not cover all types of market participants or – crucially – market intermediaries.

Implementing leverage limits for certain cohorts of funds

We agree that collecting consistent and comparable data on leverage is vital to the prudent management and oversight of investment funds – but a system-wide perspective requires similar data on the range of other types of end-investor. The lack of consistent and accessible data is an impediment to assessing potential risks associated with the use of leverage across the financial system. The proliferation of templates, formats and definitions as well as issues associated with data confidentiality and data sharing, reduces the ability of regulators to share and compare data on a cross-border basis.

We support the collection of data about leverage in funds for risk monitoring purposes using consistent and comparable measures of leverage. We are highly supportive of efforts to harmonise the definition of leverage for the purposes of regulatory reporting to facilitate global monitoring of risks and comparisons across funds (including across fund structures). The current process leads to duplication and inconsistency in reporting by firms, as well as operational complexity, with many processes requiring manual intervention.

We are uncertain about the feasibility of implementing leverage limits, except where limits are specific and narrowly targeted. Given that there is no single measure that can accurately quantify leverage for all types of funds, regulators would need to develop a suite of leverage and potential loss measures that could be collected on a consistent basis. As recognised by the CBI, the use of leverage in funds is complicated by the fact that there are multiple types of derivatives and many funds pursuing different investment strategies.

We also recognise the operational challenges identified by the CBI that could arise in trying to introduce leverage limits across the entire funds sector – the CBI's use of powers under Article 25 of AIFMD imposing leverage limits on real estate funds is a good example of an appropriately targeted and product specific approach to risk.

As noted above, it is challenging to identify pockets of 'excessive' leverage, and to distinguish between derivatives transactions that may be generated for the purposes of reducing risks or hedging (e.g., via interest rate swap derivatives) compared to leverage that is generated for magnifying returns, thereby increasing risk taking.

Moreover, because funds are not the only type of vehicle to employ leverage, any limits placed on them risk 'leakage' to elsewhere in the system. This issue would also apply to derivative concentration limits applied solely to funds. Rather than attempting to limit leverage directly, we recommend applying a products and activities lens to the funds sector, and identifying where risks that leverage generates (i.e., counterparty and funding liquidity risks) should be mitigated through targeted interventions.

System-wide leverage stress testing

System-wide stress testing cannot be used to draw conclusions about financial stability unless it can obtain sufficient data on the entire financial system, and how its constituent parts interact.

Data needs to be collected on at least the majority of market participants (including intermediaries, pensions, sovereign wealth funds, family offices and other asset owners), as well as on intermediaries such as banks and central clearing counterparties (CCPs), in order to draw meaningful conclusions about market dynamics and in this case, leverage.

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

The CBI suggests that tools addressing interconnectedness would ‘limit material spill overs’ and ‘target amplification channels’ rather than ‘underlying vulnerabilities’. It is not clear what form these tools would take that would not amount to either i) placing restrictions on funds which do not exist for other investors; or ii) targeting asset prices or price stability, which the CBI has noted is not its objective. We take each of the three options raised by the CBI in turn below.

First, it is not clear whether, when the CBI refers to limits on the market positions ‘cohorts’ can take, this means limits on derivative positions of funds, or the positions they can take in general. Nor is it clear which types of funds such a restriction might be imposed on or what its intended effect would be. However, such a policy could amount to a restriction on management of investment fund portfolios that does not exist for other types of investors or investment vehicle. The policy would therefore be discriminatory, and ineffective – as it would open up the risk of regulatory arbitrage and leakage through activity potentially shifting to vehicles that do not face the same restrictions.

Second, the CBI rightly points out that post-GFC margining requirements have somewhat resulted in a trade-off of counterparty risk for liquidity risk. However, this does not in our view represent a source of investment funds’ interconnectedness. Rather, it speaks to a structural feature of the post-GFC financial system – i.e., that spikes in volatility result in demands for liquidity and cash across the system to meet margin requirements. The demand for cash does not uniquely impact funds. Any move to introduce margining requirements solely for funds would again place limitations on one class of investors that do not exist for other investment vehicles.

However, investors’ ability to prepare for margin calls could be enhanced. Considering the lessons learned from March 2020, we recommend policymakers ensure CCPs size initial margin requirements more conservatively, using appropriate model assumptions to mitigate the potential for future pro-cyclical initial margin moves. Specifically, initial margin models should have more conservative and sound margin periods of risk, look back periods and margin offsets. Margin add-ons should be more transparent and defensible. Further, CCPs should enhance transparency to the market on specific margin rate changes to allow investors and market participants to more easily identify contracts impacted and prepare accordingly.⁶

We believe the best path forward is to focus on root causes of liquidity stress within the system. Individual market participants should be required to manage their liquidity risks such that they do not place disproportionate pressure on markets. However equal

⁶ For further discussion, see BlackRock (2022), [CCP Margin Practises Under the Spotlight](#).

focus should be given on whether excessive liquidity demands are being placed on the financial system, and whether the system has enough capacity and liquidity supply to ensure any shocks are not excessively disruptive.

Finally, the CBI suggests specific measures or higher 'resilience' could be targeted at "highly interconnected fund cohorts". This is not a well-defined concept in our view given the highly heterogeneous nature of the funds sector. Instead, we recommend that policymakers consider risks arising from specific products and activities in the funds sector, and tailor regulation accordingly.

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

A financial stability reform programme aiming to deliver greater market-wide resilience should take into account the activities of all end-investors, consider the critical role of intermediaries and market structure, and seek to improve transparency across the board – generating data that can be used to develop a comprehensive picture of market activity. These measures taken together would give a better understanding of the supply and demand for liquidity during stress events.

Detailed data on the portfolio composition of open-ended funds is available but is often missing for other investor types. Regulators should address persistent challenges around data availability on portfolios and trading activity for investors and we support the FSB's efforts to develop a systemic, ecosystem-wide understanding of the non-bank system.

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

No additional comment.

Annex 1: The Funds Sector in Context

Figure 1: Global Financial Assets by End-Investor, 2020

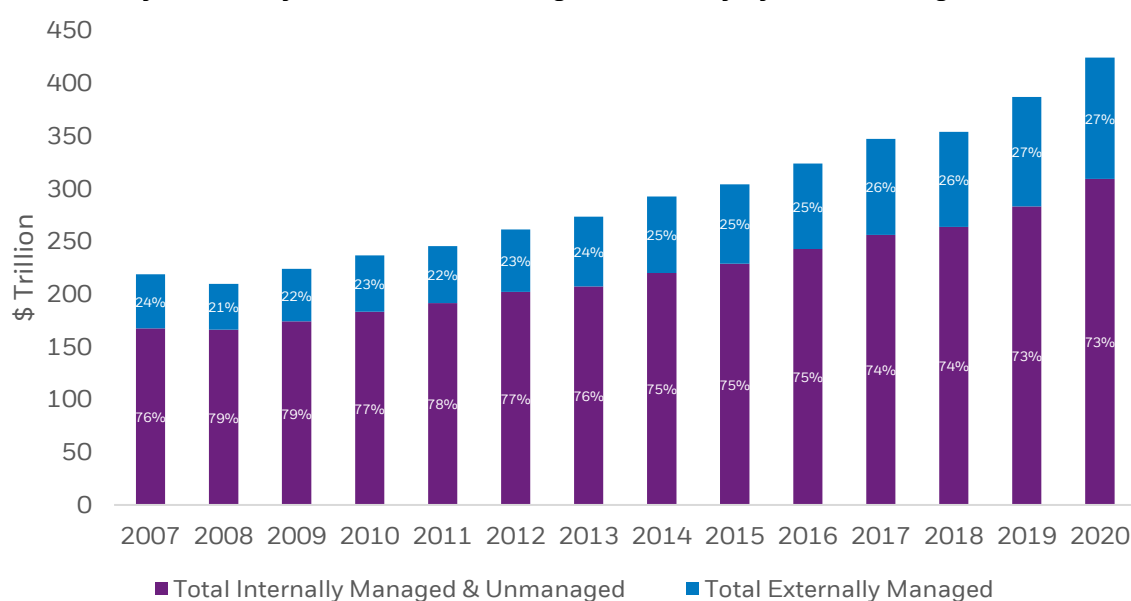
End-investors in financial markets are highly diverse, spanning retail investors, pension schemes, insurance companies, non-financial corporations, and official sector investors.

| | Total Assets (USD Bn) | % Global Financial Assets |
|---------------------------------------|-----------------------|---------------------------|
| Retail & HNW | 134,229 | 32% |
| Pensions | 42,708 | 10% |
| <i>o/w Defined Benefit</i> | 25,576 | 6% |
| <i>o/w Defined Contribution</i> | 17,132 | 4% |
| Insurance companies | 33,990 | 8% |
| Corporate Treasury | 173,452 | 41% |
| <i>o/w Financial Corporations</i> | 115,458 | 27% |
| <i>o/w Non-Financial Corporations</i> | 57,993 | 14% |
| Official institutions | 35,844 | 8% |
| <i>o/w Sovereign Wealth Funds</i> | 6,860 | 2% |
| <i>o/w State Entities & Other</i> | 28,984 | 7% |
| Endowments & foundations | 3,762 | 1% |
| All Client Segments (Total) | 423,985 | - |

Source: McKinsey Performance Lens Global Growth Cube

Figure 2: Global Financial Assets by Internal / External Management, 2007 – 2020

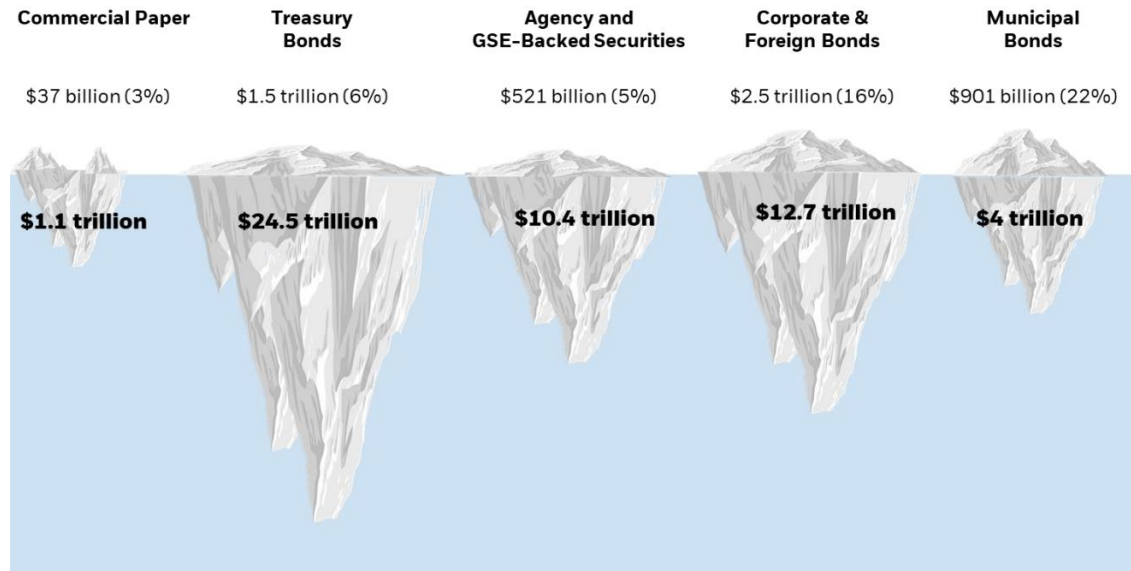
However, only a minority of assets are managed externally by asset managers.



Source: McKinsey Performance Lens Global Growth Cube

Figure 3: Mutual funds in US fixed income markets

Available data shows that open-ended mutual funds are an even smaller minority investor in markets – for example US fixed income markets.



Source [Federal Reserve Z.1 Financial Accounts of the United States](#), as of 8 June 2022. Mutual fund data excludes ETFs

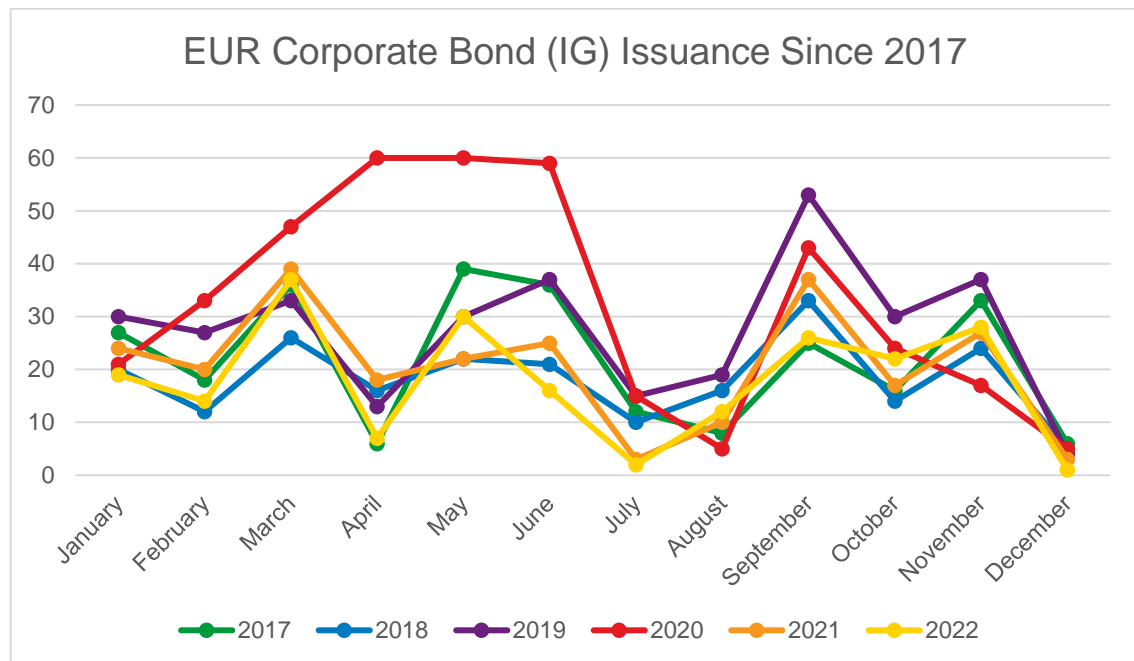
Annex 2: Liquidity Risk Management Tools

We support efforts to increase the use and availability of the full set of liquidity management tools. The below table summarises the ex-ante liquidity risk management tools used in the design phase and on an ongoing basis, and ex-post tools that are employed only rarely, that we consider to be valuable components of liquidity risk management toolkits:

| Tools: |
|---|
| Ex-ante tools at design phase: |
| An appropriate fund structure taking into account the underlying asset and intended client base of the fund. |
| Design of a liquidity management policy , including procedures to maintain levels of liquid assets appropriate to the fund structure and redemption terms. For example, alternative fund structures often include minimum notice periods that an investor must give to a fund manager of their intention to redeem their investment from the fund. |
| Valuation policies and procedures , such as fair value pricing, to manage scenarios where fund assets are difficult to value. Should include procedures to update parameters of these models promptly in response to market conditions. |
| Design of an appropriate governance structure to ensure effective liquidity risk management, with effective independent oversight or controls to deal with the information produced. This should include appropriate escalation procedures, ensure that risks to the fund are considered and managed holistically – for example, considering the inter-relationship between valuation and liquidity – and cover the allocation of responsibility for application of contingency plans. |
| Setting reasonable controls and monitoring of illiquid asset classes to ensure they do not compromise the liquidity offered to investors by the fund. |
| Prudent use of leverage with ongoing monitoring and management, and appropriate policies on funding and margining practices. |
| Consideration of the appropriateness of exceptional liquidity management tools during the design and authorisation process. |
| Disclosure to investors of pricing methodologies for subscriptions and redemptions , such as swing pricing, to manage investor expectations and inform their decisions. |
| Disclosure to investors on use of liquidity management tools , setting out actions the fund would take in the event of a liquidity problem and describing clearly how investors could be affected. For example, funds may inform investors that they will not accept deals when the underlying markets are closed on holidays, to minimise the risk of dealing in less liquid market conditions. |
| Ex-ante tools on an ongoing basis: |
| Regulators typically require that stress tests should be carried out on a regular basis based on normal and stresses scenarios (for example, atypical redemption requests). Scenarios typically include backward-looking historical scenarios and forward-looking hypothetical scenarios and are based on parameters calculated using statistical techniques or concrete stress events. |
| Ensuring sufficient sources of liquidity to meet liabilities under a range of scenarios. |
| Estimating fund redemptions based on historical shareholder behaviour under normal and adverse market conditions (which may not be revealed in a fund's redemption history). |

| |
|---|
| <p>Monitoring investor profiles and related redemption behaviours to identify potential liquidity needs, accounting for differences between institutional and retail investors, or large and small investors.</p> |
| <p>Where permitted, managers may use soft closures: closing the fund to new subscriptions while continuing to allow redemption requests. This is particularly useful where the manager assesses there are capacity constraints in accessing liquidity in the underlying assets, and where it is in investors' interests to prevent a fund from growing too large.</p> |
| <p>Ongoing use of fund pricing mechanisms and anti-dilution tools such as swing pricing and dual pricing to allocate costs of dealing in underlying assets to transacting investors.</p> |
| <p>Regular testing and updating of contingency planning procedures.</p> |
| <p>Ongoing investor disclosure and communication. Ongoing dialogue with investors who could make large redemptions is particularly important for providing advance warning of large deals and ensuring that remaining investors are not unduly disadvantaged.</p> |
| <p>Effective communication and reporting on fund liquidity and redemption profiles to regulators.</p> |
| <p>Ex-post tools:</p> |
| <p>Quantity-based anti-dilution measures such as redemption or exit fees. These are designed to protect existing or remaining investors from bearing the costs of buying or selling the underlying investments as a result of large inflows into or outflows from a fund. However, some quantity based LMTs like redemption suspensions may be taken as a signal by other investors to redeem before restrictions on accessing their investments are introduced, reinforcing the first mover dynamics.</p> |
| <p>Gates and deferred redemptions. Redemption gates are partial restrictions to investors' ability to redeem their capital beyond a certain threshold – for example 10% – with the non-executed part either being cancelled or automatically carried over to the next valuation/dealing point. Similarly, with deferred redemptions, deals are automatically carried over to a subsequent dealing point.</p> |
| <p>In-kind redemptions facilitate the exit of investors from the fund without requiring the manager to liquidate fund holdings, subject to appropriate valuation procedures. These are particularly useful for redemptions by large institutional investors with dedicated custody accounts.</p> |
| <p>Side pockets. Illiquid assets can be transferred to a separate account – 'side pocket' – pending sale and remain outside the fund's normal dealing cycle while otherwise allowing dealing in the remaining assets of the fund to continue. These are typically used in alternative fund structures and are rarely permitted in retail mutual funds.</p> |
| <p>Suspension of dealings. A suspension prevents investors in the fund from withdrawing their capital and is designed as a temporary measure for a short period of time. The purpose is to prevent excessive redemptions in times of market stress but can also be necessary when valuation uncertainty for the fund assets mean fund units cannot be priced properly.</p> |

Annex 3: Euro-Denominated Corporate Bond Issuance



N.B. Very high issuance in Q2 2020 is attributable to the ECB's intervention in the corporate bond market.

