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The macro-prudential supervision of investment funds – from a global debate to a balanced European regulatory frameworks

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Introduction

Ladies and Gentlemen,

I am very pleased to have been invited by ALFI to give a keynote speech at the occasion of its annual conference here in Luxembourg. This is actually the first time that I am attending this important fund industry event as Chair of ESMA.

In my remarks today I would like to spend some time discussing the macro prudential supervision of the investment management sector, and in particular how the remaining vulnerabilities of Open-Ended Funds (OEFs) are being kept under close scrutiny at global level. In the EU important reforms are already underway to tackle the systemic risk posed by investment funds, in particular those arising from liquidity mismatch and excessive leverage.

I will start by presenting the recent market developments in the investment management sector and our views on current vulnerabilities. Then, I will continue by giving you an update on the ongoing regulatory agenda for the investment management sector at both international and European levels, with a particular focus on financial stability and macro prudential supervision.

Finally, I will explain how, at ESMA, we go about risk monitoring and what we expect market participants to do.

The macro-economic environment and trends in the investment fund market

I probably do not need to tell you that the current economic environment has been, and will remain for some time, uncertain. In the last few years, we have gone through a succession of unexpected crises of different nature, creating unprecedented challenges for asset managers, and the economy at large. As we were just emerging from the Covid-19 pandemic, the Russian invasion of Ukraine affected dramatically the risk environment of EU financial markets. At the same time, market participants have become increasingly concerned about a global economic slowdown, or even a recession in some jurisdictions. Recovery in EU financial markets faltered, volatility increased, and market corrections materialised.

Inflation has risen sharply since mid-2021, as pent-up demand from the pandemic returned and some key supply chains faced challenges. It reached its highest level since the early 1980s in the EU, up to 11.5 % on an annual basis, in October 2022. The war and the sanctions applied to Russia increased pressures on prices from resulting supply shocks in energy, food and other commodities. Higher energy prices, reaching 10-year highs, have particularly contributed to inflation, widely increasing input and distribution costs.

As a direct consequence, central banks tightened their monetary policies to reduce demand and bring inflation back down. Interest rates increased by 3.5 percentage points in the Euro Area (EA) over one year and 4.5 points in the US, with actual and anticipated monetary policy bringing yields to levels not seen in ten years. These developments create a new economic environment for markets in general and for the asset management sector in particular.

Asset managers need to adapt to this new reality, after operating for years in a low yield and low inflation environment.

In 2022, the assets under management of investment funds experienced their sharpest decline in the EU since the Global Financial Crisis (–11% in the EA, down to EUR 16tn). Equity funds especially declined by 17%, owing mainly to valuation effects as equity markets lost as much as 20%. Contrary to past episodes of market turmoil, the impact propagated across other assets classes, including bond funds, which declined by 16% and experienced significant performance-driven outflows. Beyond the fund sector, declining valuations impacted most segments of the market-based finance system, with a 60% decline in equity issuance and a 42% decline in corporate bond primary markets in the EU. In comparison, the total assets of the banking sector increased by 5.4%.

Let me underline at this point that despite the stress we have experienced in stock and bond markets over the last year asset managers have, in most cases, managed to deal effectively with redemptions, through liquidity management procedures and tools. I will touch upon the regulatory framework and how the remaining vulnerabilities in the asset management sector are being addressed later in my speech, but I can already say that cooperation between competent authorities was efficient during these times of crises, with increased exchanges of information and intensified monitoring of liquidity and valuation issues.

Although the economic sentiment has become more positive in early 2023, at least until a week or so ago, there is no room for complacency. Risks remain elevated, first of all credit risk. Credit risk levels have remained high and are expected to rise, reflecting the concerns over public and corporate indebtedness as borrowing and refinancing costs increase. This is particularly a matter of concern for bond funds investing in the high yield segment, whose portfolio quality is at a five-year low, now having a rating between BB– and B+ on average.

But if the recent past has taught us anything, it is that risks are likely to come from sudden and unexpected shocks, coming on top of existing vulnerabilities. The liability-driven investment funds (LDIs) event in the UK has illustrated how such risks can materialise. Following the yield surge in the Gilts market, LDIs which were large investors in this market experienced sudden losses. Losses themselves were amplified by the use of leverage, and, in some cases the use of the affected assets as collateral. While the initial market shock led to margin request on derivatives, creating liquidity demands, the fall in collateral value sustained the downward spiral and created additional challenges in liquidity risk management, as the funds' primary source of liquidity had disappeared (sales of Gilts). Eventually, the LDIs redeemed from MMFs, propagating the shocks to other part of the asset management sector and the wider financial system.

What lessons can we draw from this episode in the current (again difficult) environment? The risks faced by LDIs are not specific or unique to them: any leveraged entity with concentrated directional exposures could be subject to similar stress, especially if large shocks materialise very quickly. In an uncertain and fast changing environment, and scarce liquidity, an exogeneous event can trigger simultaneous peripheral events, which may become correlated and as a consequence systemic.

While fund shares are priced very frequently to reflect the value of the assets held by the fund and the value of fund shares is not guaranteed, some funds are exposed - like other financial market players - to interest rate risks. This means that further spikes in interest rates could result in large mark-to-market losses, triggering investor outflows and forcing the manager to liquidate some of the bond holdings, thereby amplifying in turn the downward pressure on bond prices.

Therefore, it is crucial to identify, monitor and address the remaining vulnerabilities also in the asset management sector, and identify the possible channels of contagion to the rest of the financial system. This is what I will develop now in this second part of my remarks.

The right regulatory framework to address the remaining vulnerabilities in the fund sector

First, let me remind you what has already been achieved in the regulation and supervision of the investment management sector at both global and European level.

In 2008, following the Global Finance Crisis, the G20 provided regulators with a roadmap where no financial product, no market and no territory with a potential systemic impact should remain without appropriate regulation and effective supervision. This roadmap resulted in the development of an unprecedent wave of new regulatory reforms such as AIFMD, EMIR, MiFIR and CRAR in Europe. Since 2011, the European System for Financial Supervision (ESFS), which encompasses the ESRB, the European Supervisors Authorities (ESAs) and National Competent Authorities (NCAs) has been the framework for financial supervision in the EU.

However, despite the progress made in strengthening the overall framework, the Financial Stability Board (FSB) issued in 2017 new policy recommendations to address structural vulnerabilities from asset management activities. These vulnerabilities included the potential mismatch in OEFs between the liquidity of fund investments and the redemption frequency of fund units. The FSB tasked IOSCO to deliver recommendations, which were published in 2018. Similarly, at EU level the ESRB published a Recommendation on action to address systemic risks related to liquidity mismatches and the use of leverage in investment funds.

In this context, it should be noted that work is still ongoing at international level with a particular focus on the vulnerabilities in OEFs from liquidity mismatches. Last year, both the FSB and IOSCO took stock on the effectiveness and implementation of their respective recommendations. Their reports acknowledge the progress made by authorities, but lessons learnt since then, including during the March 2020 turmoil, indicate that certain further policy enhancements are still necessary. However, it is worth noting that in its report, the FSB recognised that, given the micro-prudential toolkit already available, there was no need to create, for the time being, new policy tools. The call was mainly for greater use of existing policy tools, such as Liquidity Management Tools (LMTs) and enhancing the availability of OEF-related data for financial stability monitoring.

In light of these reports, the FSB and IOSCO are now carrying out follow-up work on aspects such as promoting greater availability and use of LMTs, developing detailed guidance on the design and use of LMTs, enhancing the availability of data for financial stability monitoring and promoting the use of stress testing. The FSB is expected to adopt its new recommendations in 2023 and IOSCO is working, at the same time, on guidance on price-based LMTs (e.g. swing prices and dilution levies).

While discussions are taking place at global level, an important regulatory reform is already underway in the EU. 10 years after the adoption of the AIFMD, the European Commission published in 2021 its proposal for the review of the AIFMD (with important changes proposed also in the UCITS Directive). This proposal aims at addressing the vulnerabilities identified by global and European bodies. These include, inter alia, the development of an EU framework for the design and use of LMTs, harmonised rules for loan-origination funds and the creation of a brand-new reporting for UCITS. We therefore very much welcome the Commission's proposal. It will maintain the European regulatory framework at the forefront of the global regulatory agenda and make the European investment management sector more resilient as well as increasing investor protection. The trialogue discussion only started a few days ago and we hope the co-legislators will get to a political agreement soon.

But unfortunately, one important piece in the reforms of the EU regulatory framework is still missing - Money Market Funds.

The vulnerabilities that surfaced during the pandemic, have demonstrated that legislative changes to enhance the resilience of the money market fund sector are needed sooner rather than later. I would like to recall that we have made a number of concrete proposals in the ESMA Opinion on the review of the MMF Regulation that we believe would strengthen the European framework.

Having talked a lot about the regulatory framework so far, let me now spend some time explaining what ESMA is doing in terms of supervisory convergence and risk monitoring. Let me in that context also highlight what we expect asset managers to do to manage those risks.

Monitoring and managing the systemic risk of OEFs

As you might be aware, ESMA adopted recently its new strategy for the next five years. It will not come as a surprise that promoting stable and effective markets is one of our priorities. Indeed, in the current economic and geo-political environment, it is more important than ever that investment funds are resilient to economic shocks. In that context, liquidity and excessive leverage are the two main risks we are actively monitoring.

- Liquidity risk

Liquidity risk is obviously not a new issue in the investment management sector. From a regulatory perspective, both the UCITS Directive and AIFMD have various requirements in relation to liquidity management which are designed to mitigate this risk. UCITS especially can only invest in a range of assets that are deemed liquid and have to comply with strict counterparty risks limits. With respect to the AIFMD, there are requirements on the fund manager to put in place robust and effective liquidity risk management processes and stress tests, tailored to the specific asset classes and investment fund risk profiles.

At EU level, liquidity is a risk that we have been actively monitoring in the fund sector, especially since 2020, and the Covid outbreak. In particular, supervisory work was carried out by NCAs under a number of initiatives including, for example, the Common Supervisory Action (CSA) promoted by ESMA on UCITS liquidity risk management, as well as the work on the implementation of the ESRB recommendation on liquidity risks in corporate and real estate funds.

Some of the main shortcomings we identified through these exercises were very much consistent with those highlighted at international level. For example, these exercises showed the need to increase the **availability and usability of LMTs** by investment funds, as well as the sharing of information between NCAs. We expect the review of the AIFMD and UCITS Directive to address these shortcomings.

We expect managers to monitor the **alignment of their funds' investment strategy, their liquidity profile and their redemption policy.** In addition**,** managers should put in place accurate assessment and strong controls around the management of liquidity risk. Finally, but by no means least, these obligations should also be regularly monitored through the ongoing supervision by NCAs.

In addition, one important aspect in better managing liquidity risk is the performance of **liquidity stress testing,** to simulate the resilience of the fund sector both under normal and stressed market conditions. ESMA issued Guidelines on Liquidity Stress Testing in 2019 to help the uniform application of these tests. We expect the lessons learned from those stress tests to come in useful, now that the macro-economic environment warrants greater vigilance. That also applies to us on the public sector side. The enhanced use of macroprudential stress tests is also warranted: I believe regulators could consider running formal sector-wide stress tests to identify pockets of vulnerabilities.

- Leverage

In addition to liquidity, **leverage** is the other risk that we are actively monitoring in the fund sector. In 2021, ESMA issued Guidelines to NCAs on risk monitoring and the setting up of leverage limits for AIFs. These guidelines were issued in response to the 2017 ESRB recommendation and took into account the framework developed by IOSCO in 2020 for measuring leverage in investment funds. In light of these guidelines, ESMA and NCAs are now performing regular monitoring of AIFs' leverage, based on a common framework.

One example of data-driven supervision in this field is the leverage limit on commercial real estate funds introduced by the Central Bank of Ireland at the end of last year. As you know, Article 25 of AIFMD empowers NCAs to introduce leverage limits to curtail the build-up of risks created by leveraged funds. On 3 November 2022, the Central Bank of Ireland was the first NCA to notify ESMA of its intention to impose leverage limits on Irish real estate funds under the AIFMD. In response to this notification, ESMA issued an advice where we supported the CBI initiative and concluded that the proposed leverage limit was appropriate to address the risks created by Irish real estate funds.

Finally, it is crucial that regulators, including ESMA, have access to **detailed and timely information** to perform **risk monitoring**. With all the regulations developed after the 2008 financial crisis, securities regulators benefit from the unprecedented amounts of data, collected through regulatory reporting, that we are using extensively for financial stability monitoring. For example, ESMA has developed an advanced system of risk indicators and metrics, with wide coverage (securities markets, investors, infrastructures), building on internal research and the latest quantitative techniques for assessing complex activities (including such issues as market liquidity, interconnectedness, and the systemic dimension of hedge funds). However, there are still some important gaps that need to be addressed and, in that context, we welcome the review of the UCITS Directive which foresees the creation of an EU-wide reporting regime for UCITS.

Conclusion

It is now time to conclude.

The regulatory framework on investment management has been significantly reinforced over the last 10 years. But some further regulatory adjustments are still necessary to address the remaining vulnerabilities of the investment management sector. We believe that the ongoing EU regulatory reforms are going in the right direction, although we believe that in addition money market funds' resilience could be strengthened via improvements to the EU MMF regulation.

At the same time, we expect asset managers to assume their responsibility in managing their funds prudently in these challenging macro-economic times. OEFs need particular attention with regard to liquidity and leverage risk. Two aspects appear essential here: on one side asset managers need to prepare for further and prolonged adverse events, on the other side supervisors need to step up their efforts in assessing risks and to take adequate actions in response to the risks identified.

Thank for your attention and I wish you a fruitful conference!