



Gerry Cross

Director, Financial Regulation
Policy & Risk, Central Bank of
Ireland

Strong regulatory frameworks are the foundation of effective capital markets

The path of economic recovery from the COVID-induced shock remains unclear at this point. What is certain is that economies will need to rely on a range of sources to finance recovery, including banks and capital markets. If capital markets are to fulfil their potential, investors must be better protected and systemic risks further mitigated. A regulatory framework which prioritises these goals remains necessary to ensure the confidence that is needed for the financial system to function effectively in support of the economy.

With this in mind, regulatory authorities have long been focusing on matters related to appropriate liquidity management by fund managers, their use of leverage, and their capacity to appropriately oversee their activities and manage risk. These matters were in focus given the significantly increased role of the asset management sector following the financial crisis and subsequent regulatory reforms and were given further emphasis by events relating to Woodford, H2o and GAM funds and in light of the challenges and risks of a disruptive Brexit.

The performance of capital markets generally, and the asset management sector in particular, during the recent period of significant Covid-19-related market disruption has underlined the need to enhance the regulatory approach to these matters. It appears likely that the turbulence that was experienced during this period was exacerbated by a dynamic in the asset management sector that reflected liquidity expectations that were misaligned with the underlying assets. Moreover, the degree of central bank intervention that was required to restore the normal functioning of markets indicates the need for enhanced regulatory requirements to more appropriately apportion the cost of liquidity risk.

In order to ensure that capital markets and the asset management sector are able to meet their full potential in supporting the economy it will be important to enhance the framework relating to liquidity mismatch and leverage in funds. It will be important to address the collective action issue whereby actions taken by funds and managers in periods of stress, while rational at the individual level, may be materially suboptimal at the systemic level. This implies the need for enhanced macroprudential rules. Work underway internationally and in Europe to address the issue of leverage in the funds sector needs to be continued and brought to an impactful conclusion.

A well-regulated asset management sector plays a significant role in supporting the functioning of the financial system and wider economy. The convergence of the next phase of work on Capital Markets Union, and the review of AIFMD, with the lessons learned from the Covid-19 crisis provides the opportunity to leverage and enhance work previously underway to deliver a better performing asset management sector more effectively supporting the economy. ●