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Well calibrated policy responses required to mitigate potential vulnerabilities

At the onset of the COVID 19 shock, as financial markets turbulence, a 'flight to safety' and heightened demand for cash generally swept through a range of markets, investment funds experienced a sharp increase in redemptions and challenges in liquidity management. At an individual level, the vast majority of funds managed to meet investor redemption requests. However, this needs to be seen in the context of unprecedented central bank interventions that played a key role in restoring market functioning. Of particular concern to regulatory authorities were sector-wide dynamics evident during the period of stress. The potential for collective behaviour of funds to add to market-wide pressures in periods of stress requires regulatory change.

As an integrated central bank, prudential, conduct and AML/CFT regulator, macroprudential and resolution authority, the Central Bank of Ireland approaches regulation of the funds sector in the light of our statutory mandates of safeguarding monetary and financial stability, securing the proper and effective regulation of financial service providers and markets, and ensuring that the best interests of investors are protected. Following the COVID shock, three areas require particular scrutiny in our view.

As the COVID crisis began to unfold, Money Market Funds (MMFs) saw a substantial increase in redemptions and a deterioration in the liquidity of their assets. Redemptions were concentrated in MMFs with investments in private sector debt and this led to liquidity management challenges for those MMFs. While all MMFs managed to meet redemption requests, had any been forced to suspend redemptions or fail to meet key expectations, liquidity stresses could have spilled over to other parts of the financial system. The interconnectedness of MMFs with other parts of the financial system – including banks and other non-banks – means their resilience in periods of stress can be systemically important. Regulatory authorities are currently examining ways to strengthen MMF resilience in light of the lessons learned.

Effective liquidity management in open-ended investment funds, particularly those which invest in less liquid assets, is also an area of particular focus at present. Such funds, as evidenced during the COVID 19 shock, are particularly susceptible to the risk of large redemption requests during periods of market stress and may have to sell assets quickly in order to meet such redemption requests. The redemption patterns observed during March and April 2020 in such parts of the funds sector are consistent with the operation of first-mover advantage dynamics. There is a need to develop additional measures to address this issue. This could include measures to ensure that the costs associated with such redemptions, including increased liquidity premia in times of stress, are fully borne by the redeeming investors.

Finally, there is a need to enhance the macro-prudential framework for investment funds. The lack of a complete and operational macro-prudential framework for funds in Europe and internationally remains a key gap which is correctly gaining more attention following the recent market events.

Market-based finance, and the funds sector in particular, provides a valuable alternative to bank financing, supporting economic activity. However, like all forms of financial intermediation, they may also contribute to the build-up of financial vulnerabilities. It is important following the lessons learned from COVID shock that well calibrated policy responses are introduced in order to mitigate such vulnerabilities.