Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Perspectives on the Evolution of the Investment Funds Sector in Ireland

The Central Bank of Ireland's response to the Department of Finance Funds Sector 2030 Review

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Contents

1. Executive Summary

The Central Bank of Ireland (Central Bank) supports the Department of Finance Review (Review) of the investment funds sector with the objective of ensuring that the sector is resilient and that it delivers value for investors and for the Irish and European economies.

Investment funds are an area where Ireland has built a strong reputation, becoming the fourth largest global jurisdiction and serving the needs of investors across Europe and internationally. A high quality regulatory environment has supported this growth, along with the development of domestic funds expertise and knowledge delivered through an effective and efficient cohort of Fund Service Provider (FSPs).

This submission sets out five priority areas that the Central Bank believes will be critical to the future development of the investment funds sector in Ireland:

Delivering Positive Outcomes for the Domestic Economy and Investors	Developing a MacroPrudential Framework for Investment Funds	Maintaining Regulatory Effectiveness	Sustainable Finance	Digital Transformation
• Securing investor interests. • Ensuring good governance and customer focus in the sector. • Enabling investors to access well regulated products that meet their savings and investments needs. • Ensuring that funds deliver value for investors. • Improving financial literacy and education. • Realising the full potential of the sector as a source of alternative financing for the real economy and SMEs.	• Monitoring and managing risks to financial stability. • Developing a macroprudential framework for investment funds. • Engaging with international organisations and other national authorities to coordinate efforts.	• Ensuring that the regulatory framework remains up to date and effective. • Identifying important sectoral features and trends and developing appropriate policy and regulatory responses (delegation/sectoral change). • Supporting international policy development and sharing our expertise and knowledge.	• Supporting new product development and innovation. • Ensuring the delivery of high quality ESG products. • Supporting the sector's contribution to the transition to carbon neutrality. • Protecting investors against greenwashing.	• Encouragement and support for innovators and innovative products and services. • Supporting efforts to develop new use cases for digitalisation and tokenisation. • Managing emerging risks.

Resilient capital market financing is also consistent with the goals of the Capital Markets Union (CMU). The investment funds sector has an important role to play in providing an alternative source of financing to both the Irish and European real economies, supporting economic growth, innovation and job creation. The Review should consider how Ireland can better harness the benefits of increased capital market financing to drive domestic investment, particularly for SMEs. The Review should also consider the ongoing work at the Financial Stability Board (FSB) and International Organization of Securities Commission (IOSCO) on resilience in investment funds and the recently published Central Bank DP11 on a macroprudential approach to investment funds.

The Review should take the opportunity to consider the future strategy for the development and shaping of the investment funds sector in Ireland. It should seek to identify the areas and dynamics of potential and added value and those areas, if any, where increased growth brings little added value relative to the accompanying risks or costs including, potential reputational risks to the jurisdiction. The continued growth of the sector in terms of both its size and range of activities can benefit the domestic economy but requires careful monitoring and management to mitigate against any potential risks to either investors or broader financial stability. In this context, it is important to consider the functioning of the overall ecosystem as well as its constituent parts. The rate of growth and scale of development of the investment funds sector make this an important consideration.

The Review should also consider Ireland’s broader policy alignment with the priorities of the European CMU and Retail Investment Strategy (RIS). It should consider potential barriers to investor participation and measures to support domestic investors’ access to a wider range of well-regulated and cost-effective investment products to meet their saving and investment needs. This will enable both Ireland and Europe to realise the full potential of our capital markets and support future economic growth and job creation.

In the areas of sustainable finance and digital transformation, the Review should consider the investment funds sector’s role in supporting the transition to carbon neutrality and realising the benefits of digital transformation while ensuring the risks are appropriately managed.

For our part, the Central Bank will continue to ensure that the investment funds sector in Ireland is financially resilient, delivers positive outcomes for investors and is supported by an effective and high-quality regulatory and supervisory framework.

2. Introduction

The Central Bank welcomes this opportunity to provide its perspective on the topics set out in the Consultation Paper.

In preparing our submission to the Review, the Central Bank has set out the key sectoral developments that we believe will play a role in shaping the overall funds landscape in the years to come. It is important that as policymakers, we take a forward-looking approach to identify the sector's potential opportunities as well as its challenges so that we can anticipate and protect against new and emerging risks.

For our part, the Central Bank's 2022-2024 Strategy[1] recognises the complex and rapidly changing environment in which the investment funds sector operates. As an important constituent of the financial sector in Ireland, our four connected themes of being future-focused, open & engaged, transforming and safeguarding represent an organisational renewal and repositioning to ensure that our strategic and operational direction and ambitions are both responsive and forward-looking.

We maintain an open and engaged dialogue with stakeholders in the investment funds sector as well as other international regulatory authorities and National Competent Authorities (NCAs) so that we can better understand where the regulatory framework is working well and where improvements could be made. It is this iterative and proactive process to policy and supervision that ensures our overall approach remains effective and proportionate.

Our contribution is designed to help guide the Review's strategic perspective and reflects Ireland's position as a leading funds jurisdiction with a robust and effective regulatory environment that delivers positive investor outcomes and ensures that the future growth and development of the sector is sustainable and appropriately risk managed.

[1] https://www.centralbank.ie/docs/default-source/publications/corporate-reports/strategic-plan/our-strategy/central-bank-of-ireland-our-strategy.pdf?sfvrsn=3a55921d_4

Key Events

The sector has undergone significant structural changes in recent years, driven by factors such as the continued evolution of the EU frameworks that set the overall regulatory requirements for the sector, the impact of Brexit, the COVID-19 pandemic, the Russian invasion of Ukraine and more recently the UK Gilt crisis.

Since the Global Financial Crisis, investment funds have become one of the largest and most efficient sources of capital in the non-bank world. Ireland is the second largest domicile for regulated investment funds in the EU and the fourth largest globally with the total assets of Irish authorised investment funds exceeding EUR 3.7 trillion as of 2022. In domestic terms, the investment funds sector accounts for approximately 56% of all assets in the regulated financial sector and is the single largest component of Ireland's international financial sector supporting jobs and economic activity domestically and across Europe. Given the scale and importance of the investment funds sector in Ireland and the need to ensure that interests of investors are protected, it is important that the framework establishes and maintains a well-defined regulatory perimeter with an effective and high quality regulatory framework.

The UK's decision to exit the EU had a significant impact on the Irish investment funds sector. Several UK-authorised UCITS Fund Management Companies relocated to Ireland to adhere to EU regulations. Similarly, certain UK investment funds shifted their authorisation to Ireland to allow their continued access the EU market. Currently, Irish funds marketing in the UK are operating under the Temporary Permissions Regime but will soon need to meet the requirements of the UK's Overseas Funds Regime. The UK remains crucial as a service hub for Irish funds, particularly as many investment managers to Irish funds are based there. In looking ahead, we must take account of the potential for divergence between the UK and EU regulatory frameworks that could have a significant impact on the Irish funds industry, particularly in the areas of delegation and market access.

The onset of the COVID-19 pandemic exposed certain vulnerabilities in the investment funds sector and led to a broader consideration of the sector from a macroprudential perspective among international regulators and central banks. Lessons learned from market events in early 2020, Russia's invasion of Ukraine and the more recent UK Gilt crisis have raised concerns regarding leverage, liquidity and valuation uncertainty which have formed the basis for ongoing policy development at an international level including the FSB and IOSCO.

The 2022 International Monetary Fund's (IMF) Financial Sector Assessment Programme for Ireland determined that the financial system was broadly stable but advised that specific risks require monitoring. In particular, the IMF highlighted the need to keep pace with the large, complex, and globally interconnected financial system, noting that the macroprudential framework should be extended to cover risks from the non-bank sector, including introducing leverage limits on Irish property funds.

Discussions in international and European regulatory fora about the nature of the systemic risk posed by the investment fund sector have been ongoing for a number of years and continued more recently in light of the market events during the initial market shock brought-on by the COVID-19 pandemic in March 2020. In response, the FSB and IOSCO have undertaken several analytical and policy initiatives, including in relation to MMFs but also more broadly to liquidity management in other open-ended investment funds[2] [3] [4] [5] making this an important area of policy development in the coming years.

[2] See https://www.iosco.org/library/pubdocs/pdf/IOSCOPD666.pdf
[3] See https://www.fsb.org/wp-content/uploads/P111021-2.pdf
[4] See https://www.fsb.org/wp-content/uploads/P050723.pdf
[5] See https://www.iosco.org/library/pubdocs/pdf/IOSCOPD739.pdf

3. Delivering Positive Investor Outcomes

Summary

- Ensuring that investors' interests are protected and secured is a key priority for the Central Bank. This requires that Irish authorised funds are well governed and that they prioritise investors' interests with a clear commitment to transparency, accountability and delivering real value.
- The Central Bank recommends that the Review should:
    i. Enhance domestic policy alignment with the objectives of the European Commission's Retail Investor Strategy (RIS), particularly in the area of delivering value for investors, while engaging effectively to achieve optimal outcomes in EU development and implementation of the RIS;
    ii. Support enhanced domestic participation in capital markets through well-regulated investment products and identify and address potential barriers to investor participation in capital markets in Ireland;
    iii. Ensure the broader alignment of domestic policy with European initiatives such as CMU and RIS that aim to support increased investment opportunity, with wider more diversified sources of funding for the economy and for businesses that want to grow;
    iv. Ensure the continuing high quality governance of investment funds, that takes account of a rapidly changing environment, so that investors' interests are served and the benefits to the EU and international economy flowing from the investment funds sector in Ireland are retained and reinforced for the future;
    v. Position the Irish funds environment to respond in a timely and effective manner to the context of the significant geo-political and economic change that is underway, including to developments in the area of European Open Strategic Autonomy;
    vi. Emphasise the importance of sustainable finance and realising the full potential of the investment funds sector in supporting the transition to a net zero economy;
    vii. Build upon the learnings and analysis from the financial literacy review initiated earlier in the year by the Department of Finance. The development of meaningful financial literacy and numeracy programs are an important element of

empowering investors to both understand investment products and to make informed decisions when participating in financial markets, this should be undertaken as a matter of priority.

Achieving Positive Outcomes for Investors

All of the Central Bank's efforts across its integrated financial stability, prudential and conduct mandates are designed to protect consumers. At the core of securing positive outcomes for investors is the need for markets and firms to serve the interests of consumers through an effectively functioning financial services market where firms are sustainable, resilient and well governed while providing high quality products and choice for investors. Given the importance of financial services to the real economy and the welfare of citizens, consumer protection regulation is essential to the efficient functioning of the sector.

Aligning with European policy priorities

The Central Bank believes that it is important for the Review to consider how to best position the sector to meet the future needs of Irish and European investors, and support the implementation of the priorities set out in the CMU and the RIS.

The CMU aims to harness the potential of European consumers, investors and companies to:

- Create new opportunities for savers and investors;
- Provide a broader range of financing options to the real economy;
- Support economic development and job creation;
- Create a more inclusive and resilient economy;
- Help to deliver the European green deal and digital agenda; and
- Reinforce Europe's global competitiveness and autonomy.

The RIS aims to place the interests of consumers at the centre of retail investing. It is designed to empower retail investors to make informed investment decisions that are aligned with their needs and risk preferences while ensuring they are treated fairly and adequately protected from misconduct. These actions will enhance their trust and confidence when choosing to invest and realise the full benefits of the CMU.

Enhancing participation

While the investment funds sector has a large domestic footprint, it primarily services international investors and in particular, institutional clients. A key priority for the coming years should be improving the sectors capability to meet the needs of domestic retail investors and to drive further investment within Ireland. While European citizens have high savings rates, their participation in capital markets is lower than in other jurisdictions.

Greater domestic participation in capital markets would align our domestic policies with the objectives of the CMU and RIS, and would empower retail investors in Ireland to make informed investment decisions that help satisfy their savings and investment needs. This in turn will provide increased funding for investments in Ireland and across Europe that will support future economic growth and job creation.

The Central Bank supports the Review's consideration of how the funds sector can better support the savings and investment needs of Irish investors. It is important to consider investor access to investment funds in Ireland and to identify and address potential barriers to entry. For example, the 2020 CMU Action Plan identified a potential need for new measures to support financial education. The RIS includes a number of proposals that will help achieve this goal. These efforts could be supplemented with national measures to support retail participation in Ireland.

Learning how Irish investors identify their investment needs, how they become aware of the products available, how they access, gather and understand the information available from product providers, and identify those products that are relevant for them and how they make their final investment decision will be a critical part of delivering a positive outcome. The post-investment experience is also important in terms of how their chosen product performs, how they can engage with the provider throughout the life of the investment, particularly if they have a complaint and whether the product delivers value for money in terms of its cost versus its return.

Value for investors

A key consideration for retail investors is whether financial products deliver value for investors. This is primarily related to the cost of investing in terms of fees and taxation, both of which can impact significantly on the return investors receive from their investments. For its part, the Central Bank has conducted work in the area of fees as part of a recent Common Supervisory Action (CSA) conducted by European Securities and Markets Authority (ESMA).

The RIS seeks to encourage retail participation in capital markets by enhancing investors' confidence in markets, ensuring investors make investment decisions aligned with their needs and that investors are treated fairly and have appropriate investment protections in place. It also proposes to examine the costs to investors of investing in funds and proposes the establishment of cost benchmarks for financial products across Europe. Fund managers would be required to compare their proposed fees against the relevant benchmark and where there is a significant deviation, they must provide a rationale to justify the higher costs. This benchmarking will help to ensure that products deliver real value for investors in comparison to their peers.

ESMA has undertaken a number of initiatives in respect of undue costs over recent years. In 2020, ESMA published a Supervisory Briefing on the supervision of costs in UCITS and AIFs[6] including information on costs that may be deemed "undue" and the resulting Supervisory Briefing sought to promote convergence across Member States in the supervision of cost-related issues for funds.

ESMA conducted a CSA in 2021 on the supervision of costs and fees of UCITS in order to assess supervisory practices across Member States in relation to fund fees. In addition to assessing compliance with the Supervisory Briefing, this work included consideration of costs that were deemed "due" and "undue" for investment funds. ESMA issued its Final Report[7] in May 2022

[6] https://www.esma.europa.eu/sites/default/files/library/esma34-39-1042_supervisory_briefing_on_the_supervision_of_costs.pdf
[7] https://www.esma.europa.eu/sites/default/files/library/esma34-45-1673_final_report_on_the_2021_csa_on_costs_and_fees.pdf

and in March 2023, the Central Bank issued a 'Dear CEO' letter[8] to UCITS management companies setting out the key findings of the CSA, along with the Central Bank's supervisory expectations of fund managers.

The RIS is still at an early stage of development and the Central Bank will continue to support the development of policy proposals, along with consideration of domestic initiatives in this important area.

Governance

The Central Bank believes that there should be a broader consideration of how to encourage and support the provision of other activities such as investment management within the State. This would complement the services already available from the existing cohort of FSPs while further enhancing the sector's contribution to employment and economic activity in Ireland. This would also mitigate against potential risks that may emerge in the future where the sector is reliant on key service providers from outside of the jurisdiction, particularly in third countries.

Delegation plays an important role in the Irish investment funds sector. While delegation brings benefits for the industry and investors by allowing them to access third party expertise and knowledge, it can also pose certain risks.

While regulated entities may delegate certain activities and functions to third parties, they still retain ultimate responsibility for their obligations under the regulatory frameworks and must exercise effective control over their delegates at all times.

As noted in the 2023 Central Bank Financial Stability Review[9] (FSR), the increased level of financial stability risks seen in the international macro economy and the turbulence in securities markets are amplified by the current geopolitical environment. Enhancing the

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[8] https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/common-supervisory-action-on-supervision-of-costs-and-fees-of-ucits.pdf?sfvrsn=add6991d_5

[9] https://www.centralbank.ie/docs/default-source/publications/financial-stability-review/financial-stability/financial-stability-review-2023-i.pdf?sfvrsn=87309e1d_7

depth and self-sufficiency of the EU's financial sector will also support broader financial stability and resilience. At the same time, financial markets are increasingly globalised and while it is important that potential vulnerabilities are addressed, Europe should remain open to outside capital, expertise and innovation.

Delegation is an important element of discussions at European level, in particular the ongoing discussions around European Open Strategic Autonomy and associated measures to develop Europe's self-sufficiency and resilience in the supply of critical goods and services. The increasing influence of geopolitics and efforts to build the resilience of Europe's internal markets are important issues for Ireland, given our position as a small open economy and as the home to a large investment funds sector that itself is a significant part of the globally interconnected financial system.

The Central Bank has implemented robust requirements to protect against letterbox entities and ensure effective oversight of delegates by fund management companies. In 2016, the Central Bank published guidance on FMC governance, management and effectiveness. Since that time, the Central Bank has continued to develop and refine our domestic rules to ensure that they reflect not only EU level requirements, but also that firms also meet our expectations in terms of their substantive structures, activities and risk profile in Ireland.

The proposals regarding delegation contained in the AIFMD Review is the start of a longer-term process that will take a deeper and more comprehensive look into delegation in Europe. Linked to this, the focus on supervisory convergence will have a significant part to play in this process, with continued emphasis on delegation and outsourcing and ESMA is expected to carry out a peer review in this area in 2024. The improved data reporting on delegation set out in the AIFMD Review will assist European regulators in understanding the nature and extent of delegation across jurisdictions. The Central Bank's evolving supervisory approach seeks to enhance our engagement with delegate entities to gain meaningful insight into the work they do on behalf of our regulated entities.

Structural Changes in the Funds Sector

The nature of activity carried out by authorised entities is also changing with an increasing number of fund managers also engaging in MiFID services or seeking to provide certain services to other investment funds on a third party basis. These activities give rise to different types of risk. The Central Bank considers these activities from the perspective that similar risks should be subject to similar regulatory requirements and outcomes.

Given the increasing size and number of authorised entities engaging in a wider range of activities, the Central Bank is reviewing its domestic requirements to ensure that there is a level playing field between the different regulated entities in the interests of investor protection and financial stability.

Earlier this year the Central Bank consulted on CP152 – Own Funds Requirements for UCITS management companies and AIFMs authorised to perform discretionary portfolio management. The measures consulted on are designed to address the discrepancy in capital requirements between UCITS management companies and AIFMs with MiFID investment firms that provide similar services (i.e. MiFID portfolio managers).

As FSPs increasingly seek to diversify their service offerings, particularly on a third party basis, it will be important to ensure that the relevant rules and requirements are applied equally and that any potential for regulatory arbitrage is prevented.

The decline in self-managed fund structures over the last 2-3 years, which has come about due to large-scale restructuring, predominantly as a result of the migration of business to third party FMCs, has resulted in significant growth in FMCs providing services to third party investment funds. The scale of FMCs operating this business model has grown significantly since 2019. It is essential that these FMCs have the capacity to take on this additional business without compromising the expected standards set out in the framework or reducing the protection of investors as set out in the Central Bank's 'Dear CEO' letter issued in December 2022[10].

As the market is dominated by a relatively small number of FMCs responsible for a large number of the investment funds domiciled in Ireland, this gives rise to potential concentration risks. The Central Bank is now focussing on assessing the potential for and management of conflicts of interest within the third party model.

Guidance on the Treatment, Correction and Redress of Errors in Investment Funds

As part of our commitment to continuously enhancing our investor protection rules and supporting better outcomes for investors, the Central Bank is currently finalising domestic guidance on the Treatment, Correction and Redress of Errors in in the investment funds sector. As this is an issue that is not explicitly addressed in the European frameworks, the Central Bank launched CP130 in 2019 setting out a range of measures for the redress of errors that may arise in funds.

This work has been informed by the Central Bank's thematic review of the industry's approach to the treatment of Net Asset Value (NAV) pricing errors and the IMF recommendation that such rules be published in accordance with the IOSCO Objectives and Principles of Securities Regulation[11].

Financial Literacy

Financial literacy and numeracy is an important element of allowing investors to process and understand information about financial products. Feedback has indicated that retail investors can struggle to access information that is clear, comparable and understandable. They may not always receive advice that is in their best interest and may be unduly influenced by certain types of marketing.

[10] https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/dear-chair-letter-follow-up-on-thematic-review-of-fund-management-companies-governance-management-and-effectiveness.pdf

[11] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf

Improving financial literacy and numeracy is key to empowering investors to make their own decisions and to interact effectively with the financial services sector. The Central Bank is very supportive of broader efforts to build financial literacy in Ireland and notes the initiatives underway in this regard.

4. Developing a Macroprudential Framework for Investment Funds

Summary

- The development and operationalisation of a macroprudential framework for investment funds is a priority for the Central Bank and an important area of engagement with key stakeholders domestically and internationally.
- The Central Bank recommends that the Review should:
    i. Consider the financial stability risks associated with the continued growth of the investment funds sector in Ireland and its increasingly important role in financial intermediation within the context of discussions at the FSB and IOSCO; and,
    ii. Note the Central Bank's recently published a Discussion Paper[12] on an approach to macroprudential policy for investment funds (DP11) to advance the debate on a potential approach to the development and operationalisation of a macroprudential framework for the investment funds sector.

Background

The global Non-Bank Financial Intermediation (NBFI) sector, including the funds component, has grown substantially since the Global Financial Crisis. According to the FSB's latest annual monitoring report on non-bank financial intermediation[13], total assets within the sector increased from EUR 72 trillion in 2008 to EUR 212 trillion in 2021. In Ireland, total assets increased to EUR 6.3 trillion in 2021 from EUR 1.5 trillion in 2008[14] with investment funds accounting for around 80 percent of that growth. [15]

The investment funds sector is playing an increasingly important role in the wider global financial system and is now a larger part of overall financial intermediation with strong

[12] https://www.centralbank.ie/docs/default-source/publications/discussion-papers/discussion-paper-11/dp-11-an-approach-to-macroprudential-policy-for-investment-funds.pdf?sfvrsn=23059f1d_3
[13] https://www.fsb.org/wp-content/uploads/P201222.pdf
[14] Data from the Central Bank of Ireland's Quarterly Financial Accounts.
[15] See the Central bank's MBF Monitor for more details on the sector: https://www.centralbank.ie/financial-system/financial-stability/market-based-finance-monitor

linkages to other sectors of the financial system through funding and derivatives markets and the real economy.

Increased financial intermediation through investment funds brings many benefits. It diversifies the financing channels available to the real economy and enables diversification of asset portfolios with benefits for investors. In this way, it supports broader economic activity and provides an alternative to bank financing.

However, the significant growth in the size of the sector in Ireland and the increasing range of diverse activities it is engaged in can also give rise to certain risks. It is incumbent on Ireland as a global funds jurisdiction to ensure that the sector is well regulated and resilient. We have a collective responsibility to mitigate against any potential risks to broader financial stability originating from the sector in Ireland.

The need for a macroprudential framework for the funds sector

There has been an increasing focus by policymakers and regulators globally on addressing systemic risk in the investment funds sector. International bodies such as the FSB, IOSCO, the European Systemic Risk Board (ESRB) and ESMA have all progressed work in recent years covering the role of investment funds and their relevance from a systemic risk perspective.

The approach to systemic risk assessment needs to account for the heterogeneity in investment funds' business models and the differences in the way in which investment fund cohorts can generate systemic risk. It also needs to take account of developments in the broader ecosystem of financial markets, including the composition of market participants and drivers of liquidity demand and supply.

The materialisation of systemic risk from the investment funds sector can manifest following a shock or trigger event and the interplay between two factors:

i. vulnerabilities at an investment fund cohort level (specifically leverage and liquidity mismatch); and,

ii. the interconnectedness of the investment funds sector (which can transmit and/or amplify the effects of a shock to other parts of the financial system or real economy).

For example, an exogenous shock could incentivise investors to be the first to redeem from an investment fund, triggering other redemption pressures on the fund itself and potentially spreading to other funds. In order to meet this unexpected spike in redemption requests, the funds might be forced to sell assets below their economic value, causing market dysfunction and real economy effects (on wealth, investment, employment etc.) These dynamics can impact the functioning of the underlying markets and the real economy either directly (for example in real estate markets) or indirectly (through common asset exposures). To assess the vulnerability of the investment funds sector to shocks, authorities monitor the level of leverage and liquidity mismatch of entities, as well as considering the interconnectedness of the fund cohorts (including concentration risk).

Recently, there has been significant progress in this direction, including through the FSB and IOSCO's package of measures on MMF resilience and on liquidity management of Open-Ended Funds (OEFs).[16] As the nature of systemic risk is multi-faceted and constantly evolving, developing an overarching macroprudential framework for the investment funds sector would strengthen the overall regulatory architecture.

The Central Bank's Discussion Paper on an approach to macroprudential policy for investment funds

In July 2023, the Central Bank published a Discussion Paper[17] on an approach to macroprudential policy for investment funds (DP11). The aim of DP11 is to advance the debate on a potential approach to the development and operationalisation of a macroprudential framework for the sector.

While macroprudential policy is advanced in the banking sector, it remains nascent beyond banks, including the investment funds sector. Given the global nature of investment funds

[16] See, for example, FSB (2023) and IOSCO (2023) on OEFs and FSB (2021) on MMFs.
[17] https://www.centralbank.ie/docs/default-source/publications/discussion-papers/discussion-paper-11/dp-11-an-approach-to-macroprudential-policy-for-investment-funds.pdf?sfvrsn=23059f1d_3

and capital markets, macroprudential policies for the sector will be most effective if regulators coordinate. This underpins the importance of developing a globally consistent approach.

DP11 is designed to engage stakeholders, domestically and internationally, on the most important issues related to the development of a comprehensive macroprudential framework for the investment funds sector. It represents the Central Bank's perspective as both the macroprudential authority and the securities markets regulator in Ireland. It aims to generate feedback from stakeholders to help inform the Central Bank's participation in international and European regulatory discussions on the topic, as well as its policy and analytical work on investment fund issues more broadly.

The Discussion Paper sets out the following key principles that could support the design of a macroprudential framework for funds:

- In the case of investment funds, resilience-enhancing measures need to work on a collective or aggregate basis, aimed at fund cohorts;
- It is important that resilience is built before crisis conditions occur. Sufficient ex-ante policies should be in place, targeted at the identified sources of systemic risk, though ex-post tools nevertheless remain important as part of a wider intervention toolkit;
- Policy measures could either seek to limit underlying vulnerabilities and/or be targeted at the interconnectedness of the sector, reducing contagion risk;
- As the nature and magnitude of systemic risks evolves, it is important that policies have a degree of flexibility over time;
- Policy intervention should be the result of a careful balance between costs and benefits for the broader economy; and,
- Global co-ordination is a critical enabler when designing a macroprudential policy framework for the funds sector. It is also important that macroprudential measures take a system-wide perspective and guard against the possibility that risks shift to other jurisdictions or parts of the financial system.

It also sets out a range of potential macroprudential tools for the funds sector, covering liquidity management, leverage and interconnectedness. These include the re-purposing of existing tools but it also suggests that new, bespoke macroprudential tools for the sector may be warranted in certain instances.

Finally, DP11 outlines some key considerations in terms of operationalising a macroprudential framework for investment funds, including:

i. the need for international coordination in the development and application of macroprudential tools for the funds sector, including a reciprocation framework;
ii. the role of regulatory authorities and internal risk management; and,
iii. data requirements in terms of informing analysis and policy making, including an internationally consistent data framework.

Notwithstanding the need for an internationally-coordinated approach, in certain circumstances, domestic action may also be required. In November 2022, the Central Bank announced the phased implementation of measures to limit leverage and liquidity mismatch in the Irish resident property fund sector. The phased implementation of these measures underscores the Central Bank's determination to take action where necessary, whilst also seeking to advance the global debate on the development of the macroprudential framework for the investment funds sector.

The development and operationalisation of a macroprudential framework for investment funds is a priority for the Central Bank. We will continue to engage on the subject internationally and domestically with key stakeholders.

5. Maintaining Regulatory Effectiveness

Summary

- EU frameworks including the UCITS Directive and AIFMD set out the rules and requirements that apply to investment funds established in Europe and more widely. Their quality have created very significant brand value for EU (and Irish) non-bank investment and funding mechanisms.
- The Central Bank plays a leading and active role in supporting the development of policy at a European level in relation to investment funds to ensure the frameworks remain effective and responsive to developments in the investment funds sector and to support greater supervisory convergence across EU NCAs.
- The Central Bank recommends that the Review should:
  - i. Reflect the importance of ongoing engagement in Europe and internationally to ensure the continued value and credibility of the UCITS and AIFMD brands. This includes:
    - a) The development of harmonised regulatory frameworks and supervisory convergence across the EU;
    - b) Deploying effectively the insights, expertise, and perspective of Ireland as an open economy with particular expertise in financial services policy development and supervision to influence EU discussions relating to Open Strategic Autonomy and the future shape of the European financial system;
    - c) Contributing to and influencing the current review of the UCITS Eligible Assets Directive;
    - d) Supporting the closure of gaps in the regulatory framework that give rise to regulatory arbitrage such as the Central Bank's current proposal related to the capital requirements for UCITS management companies and AIFMs authorised to perform discretionary portfolio management;
    - e) Supporting the closure of data and informational gaps to support greater supervisory convergence, particularly with respect to delegation and investor money flows; and,

f) Supporting the maintenance of a clear regulatory perimeter where innovation is encouraged but the boundaries between regulated products and unregulated products are clearly defined.

ii. Reflect the importance of working with other EU authorities and peers, to share our insight, knowledge and experience and to support the continued development of high quality regulatory frameworks in the investment funds sector including;

a) Supporting the implementation of the measures contained in IOSCO's Final Report on ETF Good Practices.

b) Supporting the implementation of a stand-alone chapter of the AIF Rulebook to provide for ELTIFs.

Background

The regulatory framework for investment funds in Ireland is based on the rules and requirements set out at European level and supplemented by domestic rules and guidance developed by the Central Bank. The framework is kept under continuous review to ensure it remains up to date and proportionate in addressing potential risks posed by investment funds to investors. The Central Bank actively supports the development of European policy.

European frameworks

The European frameworks are designed to establish a level playing field and common supervisory approach across the EU. ESMA has a particularly important role in this area by ensuring consistency between NCAs in their approach to the authorisation and supervision of funds. The Central Bank plays an active role in developing policy interventions at European level and regularly engages with ESMA and other NCAs on issues of mutual interest.

As the European Commission is responsible for the development of the European frameworks, the Central Bank has provided only a brief overview of those elements that directly impact on our mandate and priorities.

The Central Bank is the single administrative competent authority for the purposes of the authorisation and supervision of investment funds in Ireland. There are two main categories of funds authorised by the Central Bank:

- UCITS (Undertakings for Collective Investment in Transferable Securities)
- AIFs (Alternative Investment Funds)

Irish authorised funds are also subject to other EU legislative requirements such as the European Market Infrastructure Regulation (EMIR), the Benchmarks Regulation, the Securities Financing Transaction Regulation (SFTR), the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation, the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation.

Domestic Requirements

The Central Bank has supplemented the European frameworks by introducing additional domestic regulation and guidance set down in the Central Bank UCITS Regulations[18] and the Central Bank AIF Rulebook[19].

We have also provided supporting Q&As to provide further clarifications in response to queries from industry on the implementation of the regulatory frameworks.

Central Bank UCITS Regulations

The Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) (Amendment) Regulations 2019, S.I. No. 230 of 2019 (Central Bank UCITS Regulations 2019) became effective from 27 May 2019.

These regulations consolidated amendments made in two previous Central Bank UCITS Regulations, and brought together requirements arising from (i) general amendments arising from a review of the Central Bank UCITS Regulations, (ii) amendments to UCITS Share Class Provisions to reflect the ESMA Opinion on UCITS Share Classes, (iii) amendments related to UCITS performance fees; and (iv) amendments arising from the implementation of the EU Money Market Fund Regulation (MMFR).

[18] https://www.centralbank.ie/regulation/industry-market-sectors/funds/ucits/legislation

[19] https://www.centralbank.ie/regulation/industry-market-sectors/funds/aifs/guidance

AIF Rulebook

The AIF Rulebook contains the Central Bank's guidance for AIFs, and sets out requirements for Retail Investor AIFs, Qualifying Investor AIFs, AIF Management Companies, Fund Administrators, Alternative Investment Fund Managers and AIF Depositaries. The most recent version of the AIF Rulebook was published on 14 March 2018.

The AIF Rulebook supplements the requirements imposed by AIFMD, and sets out the conditions that the Central Bank applies to Irish AIFs and AIFMs. The Central Bank imposes these conditions within the letters of authorisation issued to each individual AIF or AIFM approved by the Central Bank.

The Central Bank's Regulatory Approach

The Central Bank's mandate, which is founded on the Central Bank Act 1942, requires the proper and effective regulation of the financial sector in Ireland while ensuring overall financial stability and that investors and consumers are protected. The Central Bank's regulatory priorities are risk-based and reflect the evolving nature of the broader environment in which it operates.

As policymakers, an important consideration when contemplating new regulatory interventions or rules is whether we are regulating in a manner that ensures that the risks are appropriately addressed while avoiding imposing excessive costs on the market, and ultimately on consumers. It is important that as a public authority with extensive regulatory and supervisory powers, that the Central Bank along with other policymakers and stakeholders, continue to be challenged on our efficiency and effectiveness.

We have been - and continue to be - clear in our articulation of the trade-offs we face and the judgements we make. This enables us to engage with stakeholders in an open and transparent way and allows them to hold us to account for our actions. This approach informs our decisions and ensures the public's trust in the Central Bank.

The focus of the Central Bank's regulatory intervention in the investment funds sector is to:

- protect investors (which includes promoting and safeguarding the integrity of funds markets and maintaining confidence in the investment funds sector among potential investors and the public generally); and
- identify and mitigate systemic risks to financial stability that may arise from the activities of the sector.

Regulatory interventions in the market based finance sector range from the oversight and monitoring of the activities of investment funds and their service providers to, in certain circumstances, the resolution of distressed entities. Supervision is conducted through rules and guidance, gatekeeping, supervisory engagement and regulatory actions including the use of enforcement powers.

In an increasingly globalised financial sector, the development of effective policies for regulating and supervising financial markets relies on the cooperation of national and international authorities. Ireland's regulatory and supervisory framework, for example, primarily derives from the EU. In the aftermath of the Global Financial Crisis, there has been an increasing emphasis on the need to develop a harmonised regulatory approach across the EU.

Regulation and supervision across all financial sectors continue to be underpinned by the Central Bank's rigorous authorisation procedures, the assessment of applications for approval of persons under the fitness and probity standards, development of financial regulation policy, and an assertive risk-based approach to supervision coupled with targeted and proportionate enforcement action. The Central Bank engages with key stakeholders through open dialogue, including hosting regular meetings with applicant firms and established fund managers.

It is also important to note that there is an overarching obligation within the Irish regulatory framework that require the directors and managers of UCITS management companies and AIFMs to have a duty to act in the best interest of investors and the integrity of the market and to treat all investors fairly.

Given the financial stability risks that can be generated or amplified by the investment fund sector, the development and operationalisation of a macroprudential framework for investment funds has been a priority for the Central Bank. Our engagements with a range of public authorities, including central banks, securities regulators, international standard-setting bodies, both internationally and within the EU, as well as our participation in a range of international fora is fundamental to the achievement of this goal. Where relevant, the Central Bank will take steps domestically to mitigate potential risks to financial stability generated by cohorts of the funds sector.

Fitness and Probity (F&P)

Individuals assigned key responsibilities for an investment fund or a designated role within a regulated entity must meet the Central Bank's fitness and probity requirements in order to be approved to act on behalf of the entity. The F&P system aims to safeguard consumers by ensuring that financial services are provided by capable and ethical individuals. The Central Bank has the authority to take disciplinary measures against individuals employed in the industry that fail to meet the relevant requirements. The fitness and probity framework is consistently reviewed by the Central Bank to ensure its efficacy in safeguarding investors and to uphold market integrity.

Fund Service Providers (FSPs)

The Central Bank is responsible for the authorisation of FSPs. FSPs consist of Fund Management Companies (FMCs), Fund Administrators and Fund Depositaries. As part of the FSP authorisation process and in order to facilitate an applicant's understanding of Central Bank authorisation processes and expectations, the FSP Authorisations Team generally organises a pre-engagement meeting with FSP applicants. Following the initial meeting there is an iterative process of comments and feedback between the Central Bank and the entity until authorisation is granted.

Fund Administrators and Depositaries are authorised under domestic legislation. The Central Bank has noted that these applications tend to be at a lower volume than applications for FMCs. However, there has been an increase in applicants since 2021, which has been driven by the introduction of a regulatory regime for a specialised depositary authorisation (i.e. Depositary for Assets Other than Financial Instruments "DAOFI") and the recent changes in the Investment Limited Partnership Act which has given rise to a cohort of firms that specifically cater to less liquid AIFs.

Between 2018 and 2022, the Central Bank authorised 135 FSPs. The majority of these authorisations (62%) occurred in 2018 and 2019, driven largely by Brexit as UK FMCs sought to relocate their operations to an EU jurisdiction. While the level of applications since 2019 has decreased, there is still a steady pipeline of applications with an average of 20 applications for approval submitted to the Central Bank each year.

In recent years, there has been a discernible trend of an increasing number of FMCs seeking MiFID permissions; 45 FMCs (39%) authorised during the period have sought MiFID permissions. Such applications are more complex due to their risk profile and, as a result, are subject to an increased level of scrutiny during the authorisation review process.

Investment Funds Authorisation and Post-Authorisation

As the responsible authority for the authorisation and supervision of investment funds established in Ireland, the Central Bank is committed to providing a clear, open and transparent authorisation process while ensuring a rigorous assessment of each application against the applicable regulatory standards.

The requirements related to the information and documents to be provided in support of an application for authorisation are set out in the relevant regulations and AIF Rulebook. Comprehensive sets of application forms must be completed and applications are robustly reviewed by the Central Bank. Relevant legislative provisions and regulatory requirements must be met in order for authorisation to be granted by the Central Bank.

The Central Bank supports an open dialogue with applicant funds and where appropriate, encourages pre-meetings before applications are made. This approach brings efficiencies and cost savings for applicants.

There can be an enhanced level of scrutiny to certain investment fund applications, wherein applications that comprise particular securities with known regulatory concerns or otherwise have unusual features are required to provide additional documentation to evidence the fund's appropriateness for authorisation.

In 2018, the number of applications received was approximately 1,100 reflecting post-Brexit trends. However, on average the Central Bank authorises approximately 800 investment funds each year representing a significant area of activity and resource focus for the Central Bank.

In 2022, the number of authorisations decreased slightly. This is generally as a result of (i) the macro-economic environment, (ii) other regulatory / legislative change such as disclosure changes required under the EU Sustainable Finance Disclosure Regulation (SFDR) and (iii) other market distribution events such as the UK debt market crisis after which fund managers opted for a 'wait and see' approach towards year end rather than launching new products. However, the start of 2023 saw the Central Bank receiving 64 new UCITS applications in December (compared to only 18 new applications in November 2022).

In addition to authorisation activity, there is a considerable amount of post-authorisation activity undertaken. For example, an estimated 3,400 post authorisation submissions were reviewed by the Central Bank in 2022.

Supervision

Supervision is key to ensuring regulated entities comply with the relevant regulatory requirements.

Our approach to supervision is risk-based, data-driven, intrusive and challenging, allowing us to monitor and engage with regulated entities on an ongoing basis to identify where there may be potential risks emerging and to take appropriate action to mitigate against threats to investors or financial stability arising from the actions of our regulated entities.

The Central Bank reviews all aspects of regulated entities' businesses to assess whether they are complying with the relevant regulatory requirements, at both entity and product level, and are being run in a sound manner. The Central Bank also conducts on-site visits with firms and meets with key decision-makers.

More specifically, the degree to which FSPs are supervised is based on the specific risks they may present to the financial system or to consumers. This risk is measured by the Probability Risk and Impact SysteM (PRISM) developed by the Central Bank. This framework supports our risk-based supervision as it enables the Central Bank to assess the impact of risks posed by individual regulated entities on financial stability and to intervene to mitigate potential risks.

Entities with a greater potential impact on financial stability, prudential and/or conduct are subject to structured engagement plans with the Central Bank and those entities that are deemed to have a lower adverse impact on financial stability are supervised reactively and through thematic assessments conducted by the Central Bank.

Data is also important in supporting the Central Bank's risk-based approach to supervision. Data gathered through submissions in line with legislation such as AIFMD, EMIR, MIFIR, and SFTR, for example, allow the Central Bank to monitor risk effectively, and direct supervisory action appropriately. The Central Bank expects firms to ensure that they allocate sufficient, appropriate resources to gathering high quality data, and meet the regulatory requirements in relation to this data.

While data underlies all aspects of the Central Bank's supervisory strategy, direct pro-active and reactive engagement and thematic inspections will remain significant tools for supervision. Furthermore, ESMA Common Supervisory Actions (CSA) - coordinated supervisory activities carried out by ESMA and EU NCAs to assess the implementation and application of EU financial market legislation by financial institutions and other market participants – are becoming a significant part of the investment funds supervisory framework.

Enforcement and resolution

The Central Bank's enforcement process seeks to ensure that regulated firms and individuals are held to account where their behaviour fails to meet required standards. Enforcement action seeks to promote the behaviours we expect in the regulated financial services sector, and to deter non-compliance.

Where a regulated firm is not meeting the Central Bank's expectations, we review all of the tools available in our 'regulatory toolkit' to determine the most appropriate and proportionate course of action to achieve our objectives including the sequential or combined deployment of our supervisory and enforcement powers. From the Central Bank's perspective, it is important to seek a remedy and corrective actions to ensure investors are protected and financial stability is maintained.

The Central Bank will engage with entities to determine if this objective can be achieved. In some cases, a remedy may not be feasible and this may lead to enforcement proceedings against the entity. The Central Bank has conducted a number of enforcement actions against FSPs of Irish investment funds. Enforcement action remains a vital tool to safeguard both investors and the integrity of financial markets.

Unregulated Activity

Unregulated activities are broadly considered to be products and firms that are outside the scope of EU and domestic legislation. In respect of the regulatory perimeter, the Central Bank considers whether a particular cohort of entities, activities or products poses a threat to financial stability, investor protection or financial crime. It is also important to consider data gathering beyond the current perimeter to identify potential risks from areas not subject to regulatory reporting.

Bringing a new area of the financial sector under the Central Bank's oversight is a significant policy decision and is informed by the potential risks posed by those entities or activities to the financial system and consumers. In deciding to bring an activity or sector within the regulatory perimeter, legislators need to evaluate the potential risks posed and strike a balance between imposing the costs of regulation on the sector against the broader public interest in protecting financial stability and consumers. New regulatory requirements may make market entry more costly and increase product prices or may inadvertently be perceived as legitimising an activity that poses a threat to investors or financial stability.

The provision of unregulated products and services by regulated firms can create a lack of clarity on the regulatory status of those products. It is important for firms to engage actively with the Central Bank's work on the Consumer Protection Code, which touches directly on this matter.

Stakeholder Engagement

As part of ensuring our overall approach is effective and proportionate, being open and engaged is a key strategic theme for the Central Bank and an essential element of the ongoing development of our policy and supervisory approaches. It is important that we listen to our stakeholders, building dialogue and learning, to maintain overall trust and confidence in the financial system and foster a wider understanding of the Central Bank's role.

Alongside our direct supervisory interactions, the Central Bank has a programme of extensive engagement with industry representative bodies, other relevant stakeholders and at relevant European and international fora. This engagement provides an opportunity to liaise with our stakeholders, to listen, understand and value the perspectives of others, to outline forthcoming regulatory developments and supervisory plans, and to discuss emerging risks and issues that have come to light as a result of our work.

The Central Bank engages on an ongoing basis with stakeholders, including a quarterly meeting with representatives from the investment funds sector. At times, the frequency of these meetings is increased to address specific or urgent matters impacting the investment funds sector, such as Brexit and COVID-19.

In addition to our ongoing engagement with industry, the Central Bank has worked extensively to deepen our stakeholder engagement through a more structured framework. The Central Bank has hosted a number of conferences, inviting both domestic and international stakeholders.

Key highlights of this engagement framework relevant to the investment funds sector include:

- The Central Bank's inaugural Financial System Conference held in November 2022, which brought together stakeholders from Ireland and across the EU to discuss and debate the driving forces shaping the financial system. The conference was attended by 35 speakers, who addressed 580 attendees over two days. As part of the conference agenda, the CEO of Irish Funds participated in a panel discussion on regulating in a global world.
- The establishment of the Financial Industry Forum in 2022, which enables formal and constructive two way dialogue with senior financial Central Bank and industry representatives on strategically important cross-sectoral issues. The Forum is chaired by the Central Bank's Governor and the Members of the Forum include representative bodies from across the financial sector, including the investment funds sector. In early 2023, three sub-groups were established focusing on Domestic, International and Innovation matters and the investment funds sector is also represented on each of these groups.
- A seminar on Sustainable Finance for the asset management industry was hosted by the Central Bank in November 2022. This seminar brought together industry and regulatory representatives to discuss disclosure and data availability topics and was followed by the publication of an Information Note[20] on sustainable finance.
- The establishment of a Climate Risk and Sustainable Finance Forum in 2022 for building a shared approach to the understanding and management of the risks and opportunities posed by climate change to the financial system. Its membership comprises climate change experts, representative bodies (including investment funds) regulated firms and representatives from the Central Bank.
- The Central Bank hosted a joint FSB/IOSCO Stakeholder outreach event in relation to open-ended investment funds in July 2023.

[20] https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/sustainable-finance-asset-management-sector-disclosures-investment-processes-risk-management.pdf?sfvrsn=996f9b1d_5

6. Sustainable Finance

Summary

- Ireland's investment fund sector has an important role in supporting the transition to a more sustainable economy;
- The recent period has seen important legislative developments and initiatives setting requirements for the financial system relating to climate change and the transition to a green economy.
- The Central Bank recommends that the Review should aim to promote:
    a) A commitment to a high quality, outcomes focused implementation of climate- and sustainable finance-related regulation;
    b) A recognition of the opportunities for the investment funds sector to play a significant role (domestic, European and international) in the transition to a net zero economy and to create a new platform for continued success in this area;
    c) A recognition that achieving this will require a high level of commitment by all stakeholders. There will be a need for strong alignment across firms' culture, governance, product offerings and communications. Success will require high levels of credibility amongst stakeholders;
    d) Determined engagement in Europe to further enhance and develop the regulatory approach including ensuring that the framework is pragmatic and transition-focused; and,
    e) The development of European fund naming conventions that are clear, meaningful and straightforward to implement.

Sustainable Finance

The Central Bank's Strategic Plan 2022-2024[21] sets out our strong commitment and determination to strengthen the resilience of the financial system to climate change as well as harnessing its ability to support the transition to a low-carbon economy. The Central Bank

[21] https://www.centralbank.ie/docs/default-source/publications/corporate-reports/strategic-plan/our-strategy/central-bank-of-ireland-our-strategy.pdf?sfvrsn=3a55921d_4

sees addressing climate change as a strategic priority, and believes that the financial system has to be resilient to the risks it poses as well as having an important role to serve the needs of consumers and the wider economy in the transition to a carbon neutral future. Investment funds in Ireland can play an important and significant role in supporting and driving the transition to a low carbon economy.

Over recent years, we have seen a number of legislative changes at European level which seek to support the transition to climate neutrality, including the Sustainable Finance Disclosure Regulation (SFDR); the Taxonomy Regulation; amendments to the UCITS Directive, AIFMD and MiFID II; and the Corporate Sustainability Reporting Directive (CSRD), amongst others. The fast-paced regulatory evolution in this area demonstrates the significant need to take action to achieve the objectives of the European Commission's sustainable finance strategy.

In parallel to the regulatory changes, there has been a demonstrable shift in individuals' approach to climate change with investors seeking products that offer sustainability and ESG ambitions. It is only by ensuring the trust and confidence of investors in ESG products that we can support a real transition to a more carbon neutral economy and ensure investments are having a real impact in delivering on the goals of mitigating climate change and protecting the natural environment.

The Central Bank established a dedicated Climate Change Unit in 2021 to drive our agenda on climate change risk assessment and sustainable finance and in November 2021, the Central Bank's Governor, Gabriel Makhlouf, issued a 'Dear CEO' letter[22] to regulated firms setting out our supervisory expectations relating to climate, environment and other ESG issues.

In order to facilitate ongoing engagement with stakeholders the Central Bank established a Climate Risk and Sustainable Finance Forum in 2022 that enables stakeholders to discuss the implications of climate change for the Irish financial system and share best practices on embedding climate risk and sustainable finance considerations within firms.

[22] https://www.centralbank.ie/docs/default-source/news-and-media/press-releases/governor-letter-climate-expectations-november-2021.pdf?sfvrsn=1e4f921d_4

In November 2022, the Central Bank hosted an *Asset management sustainable finance seminar* to discuss a range of sustainable finance-related topics relevant to the investment funds sector, such as the impact of requirements on funds, challenges related to data availability and the Central Bank's supervisory strategy in the area of sustainable finance. The Central Bank also conducted a Gatekeeper Review of how investment funds are complying with their supervisory obligations under the SFDR and Taxonomy Regulation. The results of this work were published in parallel with the seminar[23] and the Central Bank set out expectations for funds in respect of their ESG claims and disclosures, to ensure investors have trust and confidence in green and sustainable products produced and sold from Ireland.

In July 2023, ESMA launched a CSA with EU NCAs on sustainability-related disclosures and the integration of sustainability risks. As part of this work, the Central Bank will assess the compliance of UCITS management companies and AIFMs with provisions under the Taxonomy Regulation, SFDR and other sustainability-related requirements. The results of this work will seek to achieve, amongst others, greater convergence and transparency across Member States in respect of the sustainability disclosures made to investors.

Sustainable finance will be a key area of focus for the investment funds sector in the years ahead and significant steps have been taken at European level to support financing the transition to a green economy.

[23] https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/sustainable-finance-asset-management-sector-disclosures-investment-processes-risk-management.pdf?sfvrsn=996f9b1d_5

7. Digital Transformation

Summary

- Technology and technological innovation are playing an increasingly significant role in shaping how financial services including investment funds operate;
- Investment funds have the opportunity to be at the vanguard of this change, particularly in ensuring that these innovations provide investors with accessible, cost effective opportunities to invest that do not disproportionately give rise to investor detriment or systemic risk;
- Advances in financial technology and securities innovation, shape and are shaped by advances in the regulatory landscape;
- The Central Bank recommends that the Review should:
    a) Reflect the importance of engaging in Europe and domestically to support and contribute to the development of policies to secure the benefits of digitalisation and technological innovation while ensuring that the risks are managed;
    b) Support innovation in the investment funds sector: We want to help foster an innovative, resilient and consumer-focused investment funds sector in Ireland, one which sustainably serves the evolving needs of consumers into the future;
    c) Focus on enhancing the capability and capacity in the investment funds sector relevant to digital transformation: Our innovation strategy also sets out an approach to enhance skills and capabilities internally to engage, understand and identify the elements of innovation on which we will focus/prioritise;
    d) Promote financial literacy to support participants in taking advantage of digitalisation in the investment funds sector.

Technological Change and Innovation

Technological change and innovation are by their nature disruptive and require new ways of thinking and interacting with our regulatory frameworks. While there are clear benefits to technological change through increased efficiencies and transparency, at the same time such change may not align with the current rules and requirements. From a regulatory perspective, we must consider the risks and benefits of these new approaches to ensure they do not lead to new risks to financial stability or investor protection – this requires an open and engaged, but balanced approach. While the Central Bank aims to support the realisation of the benefits of this innovation and change, we also need to ensure the risks are managed effectively as their impact could be significant if they materialise.

Innovation Hub

In 2018, the Central Bank established its Innovation Hub to facilitate engagement with FinTech entities and thought-leaders on innovation in the financial services sector. This engagement enables the Central Bank to develop our knowledge of the innovative products and services and better understand the associated risks and challenges and their impact on the financial system.

Part of this innovation has included developments in Distributed Ledger Technology (DLT) and tokenisation and the Central Bank has received proposals for investment funds to gain exposure to digital assets. Whilst these technologies are advancing at great pace, they are in their infancy within the financial system. As such, the Central Bank must ensure that the impact and risks related to such assets are fully understood and monitored, managed and mitigated, through the development of targeted policy measures and supervisory approaches.

Blockchain

Blockchain technology has emerged as a disruptive force in the investment funds sector. Blockchain is a decentralised and transparent ledger system, offering a database of shared records between two or more parties. It enables secure and efficient peer-to-peer transactions without the need for intermediaries. Blockchain technology has the potential to streamline various financial processes such as cross-border payments, remittances, securities trading, and supply chain finance, allowing greater accessibility and reporting to investors.

Since the emergence of Blockchain technology, it has become clear that there is a need to establish a forum amongst EU regulators to put in place a framework for regulating Blockchain. In February 2023, the European Commission launched a regulatory sandbox for innovative use cases involving Distributed Ledger Technologies (DLT). This will enhance the EU's role as a regulatory leader in the use of Blockchain and DLT in financial services.

Digital Assets

Intertwined with the use of Blockchain technology is the use of digital assets. Demand for digital assets has increased significantly in recent years and has evolved beyond cryptocurrencies alone. The digital assets sector currently lacks the rules and protections that have benefited the development of the mainstream financial sector.

In March 2022, IOSCO set up a board-level Fintech Task Force (FTF) consisting of 28 members from IOSCO Board member jurisdictions to manage delivering policy-focused work on crypto-asset markets and activities primarily relating to investor protection and market integrity. Additionally, the Markets in Crypto Asset regulation (MiCA) Regulation will be introduced in the near future. MiCA will be a first step in regulating specific digital assets, and is designed to support its further development while ensuring that the risks are addressed.

One area of technological focus and advancement to note is tokenisation. Tokenisation involves the digital representation of real (physical) assets on distributed ledgers, or the issuance of traditional asset classes in tokenised form. This has the potential to deliver a range of benefits - including enhancing liquidity, improving valuation and broadening access.

This is an area of policy and supervisory focus for the Central Bank and we will continue to engage with industry as asset managers explore the operational application of tokenisation.

In 2021, the Central Bank issued an AIFMD Q&A (ID1145) which permitted QIAIFs, subject to certain requirements, to invest indirectly in crypto assets. At the time, QIAIFs intending to gain indirect exposure to crypto assets were required to make a submission to the Central Bank demonstrating how risks such as liquidity risk, credit risk, market risk, operational risk, money laundering/terrorist financing risk and legal and reputational risk would be managed by the AIFM. The Central Bank's approach to crypto assets has and will continue to remain under review.

With the evolution of these asset types in recent years, the Central Bank updated its AIFMD Q&A (ID1145) in April 2023 to reflect the current position on investment in digital assets. At present, an open-ended QIAIF may gain indirect exposure to digital assets of up to 20% of NAV and a closed-ended or limited liability QIAIF may gain indirect exposure to digital assets of up to 50% of NAV. Direct investment in digital assets may only be permitted for QIAIFs where it is demonstrated to the Central Bank that the depositary can meet its custody or safe-keeping services obligations under AIFMD in respect of digital assets.

As the regulatory landscape regarding technology and innovation continues to evolve, the Central Bank will adapt its authorisation and supervision approaches to digital assets to ensure any changes are in the best interest of investors.

Artificial intelligence (AI)

The early impact of AI has already been seen in the investment management arena, with the advent of robo-advice. Robo-advice is the utilisation of algorithms to offer an automated investment platform and provide a cost effective, convenient personalised investment advice based on an individual's financial goals and risk tolerance.

Given the fact that AI powered algorithms can consume and process vast amounts of real time data, to enable faster and more accurate decision-making, many institutions within the wider investment funds sector are now considering how they can deploy AI technologies across the entire value chain. As an example, from a trade compliance or risk perspective, AI algorithms could identify patterns and anomalies in financial transactions, helping to detect fraudulent activities more effectively.

One area of focus for the investment funds industry, in general, is reducing the increased paperwork burden being experienced by investors, and the associated knock-on delays experienced as a result. From a sales/marketing/customer service perspective, AI-powered chatbots have the potential to provide a quick personalised assistance to customers, reducing the need for human intervention and administrative burden, resulting in an improved investor experience is significant.

Cyber Security

As technology advances in the investment funds sector, firms become increasingly vulnerable to cyber threats, data breaches, identity theft, and ransomware attacks. These incidents are also occurring on a more frequent basis than ever before and pose significant risk to investors and the investment funds sector alike. As a result, strong and effective cybersecurity frameworks and measures are essential. In an effort to protect sensitive financial data and maintain investor trust, firms utilise innovative cybersecurity solutions such as advanced encryption techniques, biometric authentication tools, anomaly detection systems, and real-time monitoring tools. Given the importance of maintaining high standards of cyber security, this will continue to be an area of further focus and development in the sector.

8. Real Estate Investment Trusts (REITs)

Summary

- The Finance Act, 2013 made provision for Real Estate Investment Trusts ("REITs").
- REITs are publicly listed companies, designed to provide investors with access to returns from real estate through a structure with the potential to provide both income and capital appreciation while limiting leverage through borrowings. A key requirement of the REIT regime is that the REIT must distribute a signification portion of its rental income.
- The Central Bank recommends that the Review should;
  a) Evaluate the current Irish REIT regime and consider the benefit of amending the regime;
  b) Consider the intersection of the AIFMD and REITs framework in other EU jurisdictions; and,
  c) Consider the societal benefits from securing further investment in commercial and retail housing stocks.

The REIT regime was introduced around the same time as AIFMD and there are overlaps between the two regimes that caused practical difficulties at its inception and may have prevented some REITs coming to market.

While the determination as to whether a REIT also constitutes an AIF will depend on the structure of the REIT and is made on a case-by-case basis. To date, the Central Bank has not encountered a REIT that it does not consider an AIF.

A consequence of a REIT being an AIF is that the AIFMD framework applies and the REIT is required to appoint an AIFM. Another consequence is that the REIT is subject to the marketing rules as set out in the Central Bank's AIF Rulebook. As a REIT is an unregulated AIF under the AIFMD regime, restrictions apply for marketing to retail investors.

The REIT regime requires the REIT to distribute 85% of its rental profits annually to the shareholders by way of dividend. In addition to the reasons set out in the Consultation Paper, this measure could be seen as advantageous from an investor perspective. From a regulatory perspective, it may also prevent high leverage.

An overall review of the REIT regime could be considered as part of future policy work. A successful REIT regime may help to provide additional liquidity in the Irish equity markets as REIT shares are admitted to trading on the regulated market like equity shares.

9. Special Purpose Entities (SPEs)

Summary

- The Central Bank has published a series of reports and research papers on the SPE sector in Ireland such as "Shining a Light on Special Purpose Entities in Ireland"[24] [25] in 2018 that highlight certain risks posed by certain types of activity in the SPE sector.
- The Central Bank recommends that the Review should:
  a) Consider the overall policy and regulatory approach to SPEs in Ireland;
  b) Complete an analysis of all SPEs operating within the State including a cost/benefit analysis of their economic function and the value they bring to the economy against the potential risks this sector can post to financial stability or money laundering/terrorist financing; and,
  c) On the basis of that analysis, determine whether further legislative or policy measures are required to address these risks.

In Ireland, SPEs are not authorised by the Central Bank and are not subject to prudential regulation. Investment funds use Section 110 SPEs as part of their investment strategy largely for tax efficiency purposes. It is important to note the distinction between an investment fund and the structures certain investment funds use as part of their investment strategy (largely for tax efficiency purposes) such as Section 110 SPEs.

While SPEs are not investment funds and do not fit within the scope of the investment funds regulatory perimeter, they do form a substantial component of the domestic financial system with approximately EUR 1 trillion in assets representing 22 percent of the Irish NBFI sector in Q1 2023.

SPEs are complex structures engaged in a wide range of activities that are often part of cross-border, multi-entity corporate structures and are generally divided into two main types:

[24] https://www.centralbank.ie/docs/default-source/publications/economic-letters/vol-2018-no-11-shining-a-light-on-special-purpose-entities-in-ireland-(golden-and-hughes).pdf?sfvrsn=8#:~:text=SPEs%20that%20carry%20out%20certain,set%20out%20in%20that%20Act.

[25] https://www.centralbank.ie/docs/default-source/publications/financial-stability-notes/no--17-mapping-market-based-finance-in-ireland-(cima-killeen-and-madouros).pdf

- Securitisation SPEs – or Finance Vehicle Corporations (FVCs); and
- Non-securitisation SPEs ('Other SPEs').

Ireland is also home to most of the European Collateralised Loan Obligation (CLO) market and a number of Irish non-bank lenders are financed through securitisation vehicles.

Potential Risks

While the overall exposure within the investment funds sector is limited, the broader SPE sector could potentially give rise to risks related to money laundering/terrorist financing or sanctions, investor protection and financial stability.

i. Money Laundering/Terrorist Financing (ML/TF)

SPEs are relatively straightforward to establish, but their complex structures make them potentially vulnerable to exploitation for money laundering purposes. There is a potential money laundering threat from transnational criminal organisations not generally connected to Ireland, that may seek to move funds through Ireland's financial system or through the use of Ireland's legal structures.

The majority of SPEs are not designated persons and are therefore not subject to supervision for AML/CTF purposes. In an effort to assess the ML/TF risks associated with the non-supervised SPEs, the Central Bank's AMLD Risk Team undertook an exercise in 2022 to use the statistical data available on SPEs to identify any ML/TF risk indicators. This analysis concluded that out of the population of approximately 3,000 Section 110 SPEs that report to the Statistics Division within the Central Bank, over 2,700 are not subject to AML/CFT supervision by the Central Bank, 5% might be considered as a high ML/TF risk, 61% are a medium/high ML/TF risk, 34% are medium/low ML/TF risk with the remainder low risk.

At the outset of the Russia/Ukraine crisis and the imposition of financial sanctions and restrictive measures by the EU on Russia and Belarus, the Central Bank conducted an assessment of the links to Russia within the Irish SPE sector. This analysis concluded that 66 of Irish established SPEs have some form of links with Russia (through their sponsor, borrower or note holders/investors) and 32 of these entities were linked to a sanctioned entity (or individual) via either their sponsor or borrower. It is worth noting that the majority of the SPEs with links to sanctioned entities/individuals are involved in the Schedule 2 activity of lending and are therefore subject to AML/CFT supervision by the Central Bank.

External financing SPEs pose a high degree of risk of sanctions circumvention, given their close links to Russia (as well as other high risk third countries) and the fact that the very existence of the Irish SPE is often reliant upon a sponsor and/or borrower in Russia or another high risk third country.

There are a number of challenges for the Central Bank in this regard:

i) Despite the fact that the majority of the Irish SPEs involved in lending to Russian borrowers are subject to AML/CFT supervision, Irish law does not impose any obligations on supervised entities to put in place systems and controls to ensure that sanctions and restrictive measures are not breached. The Central Bank therefore does not have the legal mandate to ensure that supervised entities (including the SPEs that are supervised for AML/CFT obligations) are complying with sanctions.

ii) A particular challenge that is posed by SPEs in terms of sanctions/restrictive measures is the fact that the complex structures of SPEs makes it difficult to determine if an SPE is owned or controlled by a sanctioned entity or individual and therefore subject to sanction itself. This challenge arises from the fact that the majority of Irish SPEs involved in external financing/lending are generally orphan structures ultimately owned by a charitable trust and it is therefore difficult, if not impossible to establish who is actually in control of the entity.

ii. Financial Stability/Investor Protection

In terms of financial stability, Irish-domiciled SPEs are increasingly interconnected with other parts of the international financial system, as well as increasingly concentrated in certain sectors. For instance, Irish-domiciled CLOs account for over 90% of CLO assets in the EU.[26]

[26] MBF Monitor https://www.centralbank.ie/docs/default-source/financial-system/financial-stability/market-based-finance-monitor/market-based-finance-monitor-2021.pdf?sfvrsn=2894921d_5

While the Central Bank has not identified any immediate threats to financial stability from the SPE population domiciled here, these entities may be vulnerable to broader market shocks that could make it difficult for them to continue to trade or pay their investors. There may be issues with excessive leverage, lack of liquidity and sponsor support as was seen during the GFC when the Irish SPE Ormond Quay collapsed leading to a bail out of their sponsor Sachsen Bank in Germany. [27]

A similar event could have an impact on the reputation of the Irish financial system and potentially affect the domestic economy through contagion and the interconnectedness of Irish financial institutions either directly or indirectly through common asset holdings.

[27] Financial Times 2017 here https://www.ft.com/content/67b09a1c-4d0b-11dc-a51d-0000779fd2ac

10. Annex 1 – Additional Information

Funds Sector Overview

As noted in the Department's Consultation Paper, since the establishment of the IFSC in the 1980s, the Irish investment funds industry has experienced strong growth. Since the Global Financial Crisis, the international financial system has undergone significant change. Reforms to the banking sector have resulted in a general de-risking by banks creating space for the non-bank sector and in particular, investment funds, to expand both their overall market footprint and the range of activities and services they provide.

This has led to significant growth in the assets under management held by investment funds globally and particularly in Ireland which in addition to its global ranking, is now the second largest domicile for regulated investment funds in the EU with the total assets of Irish authorised investment funds now exceeding EUR 4.1 trillion in 2022. In domestic terms, the investment funds sector now accounts for approximately 56% of all assets in the regulated financial sector and is the single largest component of Ireland's international financial sector.

Key Types of Funds

Ireland is now home to over 8,000 authorised funds, 70% of which are UCITS and 30% are established as AIFs.

1. Undertakings for the Collective Investment in Transferable Securities (UCITS)

UCITS are investment funds that are authorised under a European framework and designed for retail investors, although they are also often used by institutional investors. UCITS are generally regarded as a safe and well-regulated investment product. UCITS are designed to be well-diversified, liquid and open-ended products and can avail of the passport mechanism that allows them to be marketed on a cross-border basis within the EU.

2. Alternative Investment Funds (AIFs)

AIFs are investment funds established by Alternative Investment Fund Managers (AIFMs) and are primarily intended for investments by professional investors, though they may also be marketed to retail investors subject to certain conditions. AIFs are authorised under by the

Central Bank under domestic legislation and the relevant requirements of the AIF Rulebook are applied as a condition of authorisation.

3. Money Market Funds (MMFs)

MMFs play an important role in the global economy by providing short-term investment options, facilitating liquidity management, and contributing to the efficient functioning of financial markets.

The EU MMF market is heavily concentrated in three domiciles with Ireland holding the largest market share (45%), followed by Luxembourg (27%) and France (22%). Euro area MMFs now hold around EUR 1.5 trillion in total assets across three main base currencies (EUR, USD and GBP). LVNAV MMFs have been growing steadily in recent years, with their market share standing at 48%. Public Debt CNAV MMFs account for around 8.8% of MMF net assets while the market share for VNAV MMFs share has fallen to approximately 44%.

4. Exchange Traded Funds (ETFs)

The Irish ETF industry has experienced substantial growth in recent years and Ireland has become a prominent hub for the launching and domiciling of ETFs. Irish authorised ETFs now account for close to EUR 900 billion of assets, across a variety of strategies and mandates. Ireland's appeal as an ETF jurisdiction is underpinned by a combination of factors, including its favourable double taxation regime, expertise in fund administration, and broad support systems. Industry has demonstrated innovation and flexibility in catering to various investment strategies including thematic ETFs, ESG-focused funds, or enhancements to traditional index-tracking products.

5. European Long Term Investment Funds (ELTIFs)

As part of the CMU, ELTIF is intended to increase the availability of non-bank finance in Europe and to encourage long-term investment in the real economy in assets such as infrastructure projects, real estate and listed and unlisted SMEs. While Ireland has no authorised ELTIFs at present, the Central Bank is currently reviewing the domestic framework in light of renewed interest in these funds driven by the changes to the ELTIF Regulation proposed by the European Commission. The proposed changes to our domestic framework will ensure that

ELTIFs have a clear authorisation pathway in Ireland and that the sector is positioned to realise the future potential of these funds.

EU Legislative Frameworks

Undertakings for Collective Investment in Transferable Securities (UCITS) Directive

The UCITS Directive is a harmonised EU legislative framework that sets out the rules for the marketing, sale, and management of UCITS funds. UCITS funds are open-ended investment funds that invest in a diversified portfolio of securities. They are subject to strict regulatory requirements designed to protect investors.

The UCITS Directive has two primary elements:

- it establishes a set of rules that require the investment fund to be in a position to redeem investors' shares upon request and accordingly, restricts the funds ability to invest only in certain types of assets; and,
- it sets down specific conduct and operational standards for UCITS managers.

It is the UCITS passport that has allowed smaller EU Member States such as Ireland to establish and develop a significant presence in the investment funds sector both within Europe and internationally.

The UCITS Directive is supported by guidance and rules issued by ESMA, while the Central Bank UCITS Regulations consolidates all of the requirements which the Central Bank imposes on UCITS, UCITS management companies and depositaries of UCITS. The Central Bank has issued guidance and Q&As on a number of topics to assist market participants in complying with the requirements of the UCITS Directive and associated legislation.

Importantly, since its introduction, the UCITS framework has continued to evolve and develop and has gone through a number of iterations and updates with the most recent, UCITS VI proposal, containing amendments to the requirements related to delegation, liquidity risk management, regulatory reporting and depositaries.

Alternative Investment Fund Managers Directive (AIFMD)

The AIFMD is a harmonised EU legislative framework that sets out the rules for the marketing, sale, and management of AIFs. AIFs are a broad category of funds that do not fall within the UCITS Directive. They can invest in a wide range of assets, including illiquid assets, and are subject to less stringent regulatory requirements than UCITS. The Central Bank's AIF Rulebook details the rules imposed by the Central Bank on AIFs, management companies and service providers.

The AIFMD provides for detailed conduct and operational rules in relation to AIFMs. It does not establish rules in relation to AIFs themselves but these are provided through our domestic legislation and guidance. AIFs may invest in a wide array of assets (which may or may not be liquid) and may provide for different frequencies at which investors can redeem from the AIF (some AIFs may not allow investors to redeem until the AIF terminates).

Where AIFs are regulated, rules in relation to permissible assets for investment, investment borrowing and leverage limits are provided for by the Central Bank. While AIFs may be established in one EU country and sold in another, the process is different to that for UCITS. The European Commission recently completed a review of the AIFMD and is proposing a number of changes to the framework. Political agreement was recently reached on the package but further technical work is required on the text.

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