Matthew Elderfield: The regulatory agenda for the funds industry

Address by Mr Matthew Elderfield, Deputy Governor of the Central Bank of Ireland, to the Irish Funds Industry Association, Dublin, 12 September 2012.

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Thank you very much, IFIA, for the invitation to speak at this year's conference. IFIA plays an important role in the Irish international financial services sector and it is my pleasure to be here today to share some thoughts about the regulatory agenda for the funds industry. Before I do that, can I take a moment to acknowledge the significant contribution that has been made by Gary Palmer, as the outgoing CEO of IFIA, to the growth and success of the funds industry in this country and to thank him publicly for the good working relationship he developed with the Central Bank. Let me also welcome Gary's successor and say that I look forward to maintaining a good dialogue with Pat Lardner: indeed, that has already begun.

IFIA is an important representative body because the funds industry is an important sector for Ireland. You are all well versed on the key statistics that illustrate this, in terms of assets under management (€1.2 trillion) or number of employees in the sector (some 12,000 or so). One statistic that is not so readily accessible – and required a bit of digging around – is the number of investors in Irish regulated funds or funds supported by Irish fund administrators. There are in fact over 1.3 million such investors – a very significant number indeed. That shows the importance of the Irish market place in providing a service to investors across Europe and the world. And, indeed, it shows the important responsibility that we both have – as industry and regulator – in ensuring high standards of investor protection. These investors place trust in the Irish system of regulation and our reputation for maintaining high standards is vital to the success of the international financial services sector including the funds industry.

The key message I have for you today is that getting the regulatory framework right for investor protection is important for the reputation of the IFSC and the success of the funds industry. I want to explain that we have an opportunity to revisit and improve that framework in Europe and domestically, with respect to our regulatory processes, and by enhancing our approach to supervision.

The starting point for approaching regulation of the fund sector should be an acceptance that funds are different. The traditional concerns of the prudential supervisor do not apply to the funds industry. Nor do the traditional consumer protection issues relating to the sales process apply directly: these are not relevant to the fund or funds service provider per se, but are picked up elsewhere in terms of the regulatory framework applying to investment firms and intermediaries. Instead, our concern is one of investor protection along a number of dimensions: ensuring that the investment that is available has an appropriate risk profile for the type of customer involved; ensuring adequate disclosure to investors so they can make an informed choice about risk. addressing operational risks related to valuation or protection of assets; and, reducing the risk of fraud and other financial crime problems. There is also a new dimension to funds regulation, going beyond investor protection and considering the systemic risks posed by particular aspects of the sector, which I will return to at the end of these remarks.

This different regulatory focus correctly argues for a different supervisory approach. This involves clear standards around investment products, which as you know are mostly set at a European level. As a supervisor, it means the focus of effort is on the authorisation process and ensuring robust arrangements are in place regarding the approval of new funds and ensuring adequate disclosure. Our supervisory model is also designed to place the emphasis of our work on the fund service providers – both administrators and custodians – rather than on the individual funds themselves.

Bearing this supervisory model in mind, let's explore the individual elements and consider what changes are afoot – and what scope there is to re-engineer the current regulatory framework.

European developments

It is right that we should start at the European level. The EU is of ever increasing importance to the funds industry. The volume of initiatives from Europe in financial services generally, but with respect to funds in particular, seems at times overwhelming. The structure of regulation and standard-setting in Europe has undergone fundamental changes, with the advent of the European supervisory authorities including ESMA. And the rules that now emerge from Europe tend to have direct binding effect on financial services firms, rather than being transposed and sometimes modified by national authorities. The trend is for more Europe, affecting more parts of financial services regulation, with less national discretion.

This means that engagement in Europe is more important than ever. At the Central Bank of Ireland our strategy has been to develop specialist policy teams responsible for key areas of European directives and regulations, to invest more time in the European and international policy-making processes, to be more focused in our goals and to get in early, trying to influence European developments while they are still at the formative stage. It is important that industry also raises its game on engagement in Europe and I would encourage IFIA to carefully re-examine its strategy for European advocacy to ensure it is having maximum impact.

The need for engagement is immediate and pressing – and in the short term Ireland will have a central role to play as Presidency of the EU in the first half of 2013. This will be a big responsibility and will involve a number of complicated and high-profile portfolios, such as banking union and resolution and MIFID II. And in the funds industry there will also be important portfolios, including UCITS V and UCITS VI.

We expect the AIFMD to have mostly completed the EU legislative process by the time our Presidency begins, although certain technical standards will remain to be issued. The finalisation of Level II requirements for the sector is imminent and some important issues remain unresolved. The ball is currently in the Commission's court. A lot of disappointment has been expressed that some of the issues that were heavily debated in ESMA – and where we believe sensible proposals were reached – have been revisited and changed. I can understand that sense of frustration. For example, we think it's important to recognise that the business model of the funds industry involves a significant degree of delegation and outsourcing of activity. We hope that the final Level II text being developed by the Commission reflects the very reasonable concerns that have been expressed by stakeholders and regulators in this area.

In terms of UCITS V, there is still considerable debate on the appropriate liability regime for custody. I think it should be accepted that there will be alignment of the liability regime in UCITS V with the standards in AIFMD. Given the substantial obligations which depositories will be asked to comply with under AIFMD, we believe that UCITS V should mirror these requirements, no more, no less. Also, the Central Bank will seek to ensure that Ireland's rigorous but streamlined approach to the licensing and supervision of depositories is reflected in UCITS V.

On UCITS VI, we are at an earlier stage in the process of consultation. One central area of debate will be whether to revisit the types of assets eligible for investment in the UCITS structure. Our initial thinking at the Central Bank is that it would be inappropriate to restrict the current set of eligible assets or to impose general restrictions on OTC derivative instruments. However, the current "no look through rule" does deserve further examination in relation to particular areas such as indices, where we have seen the eligible asset restrictions arguably being circumvented. ESMA has already done some good work in its recent guidelines on the use of indices, but there may be more that can be done. We can also expect the output from the debate on shadow banking and systemic risk in the money market funds industry to feature heavily in UCITS VI.

As I mentioned, I will come back to this topic of shadow banking a bit later.

Domestic developments

Europe will clearly be the main driver of the regulatory framework for the funds industry in Ireland. But there is also, as you know, a domestic regulatory framework in place that is not derived from EU law and which in many cases predates it. The implementation of the AIFMD provides an opportunity to revisit this framework. We are working hard on AIFMD implementation with the goal of providing certainty to industry as soon as possible. My colleague Gareth Murphy, who spoke to you last year, is chairing a working group on AIFMD implementation involving representatives from the Department of Finance and industry. We will be consulting publicly on proposals very shortly. This process provides an opportunity to revisit our domestic framework for non-UCITS funds.

Let me take a little time to explain our approach and highlight one or two issues under active discussion.

We believe it is important to use the implementation of the AIFMD as an opportunity for a systematic rethink of our non-UCITS regime. Our current domestic regime has evolved piecemeal over many years in response to particular concerns and without any relevant EU standards to refer to. We now need to be prepared – in light of the implementation of this major piece of European legislation – to re-examine those elements of the existing domestic framework. Our approach will be informed by the principals included in the Taoiseach's strategy for the international financial services sector, namely the need to carefully re-examine the case for domestic standards which exceed EU requirements, in terms of establishing that they are in the public interest. We are prepared to retain additional domestic standards if we believe the public interest test is met. But our starting point is of a rigorous case-by-case reassessment of the existing domestic framework to see whether these domestic requirements need to be retained.

For example, one issue under discussion is whether we should establish a new category of fund based purely on the minimum standards of the AIFMD. This would provide a clear choice of a fund that is being managed in a way fully compliant with the relevant EU standards for pass-porting fund management without any additional domestic requirements on the fund, except as directly required by existing Irish law. This would be a major initiative and we want to see the matter very fully considered before we decide on it. As an alternative, or perhaps even in addition, we are also undertaking a rigorous reassessment of our non-UCITS qualifying investor regime. To what extent should the domestic standards for the QIF regime be adjusted to reflect the AIFMD? We are itemising the differences between the AIFMD requirements and the QIF regime for funds and reviewing each in turn. For example, our current domestic regime sets specific requirements on directed brokerage programmes. These requirements can be dis-applied in light of AIFMD where rules on conflicts of interest, best execution and annual account disclosure provide adequate comfort to investors. This would seem to be a sensible area for potential adjustment. There are a number of other areas to be considered, which will each be examined in turn.

The introduction of the directive also provides an opportunity to revisit the promoter regime for non-UCITS. The AIFMD now imposes significant requirements on fund managers, which would appear to meet many of the objectives of our current domestic promoter framework. We also believe there may be scope for us to provide additional guidance on what we expect of directors when a fund runs into financial or operational difficulties. In that context, we plan to consult on proposals to remove the current promoter regime at least for qualifying investor non-UCITS.

I should caution that our domestic framework for non-UCITS will remain in place where we believe it is in the public interest to do so. But we're serious about rigorously and systematically challenging ourselves as to which particular provisions are indeed appropriate to retain. This is a very big job. While we will have done a lot of work before going to consultation, we will not have finalised our views on all these matters. We will present what we hope will be seen to be a well-considered approach, but we are very much open to submissions. Our public consultation will offer you a real opportunity to challenge any aspect of the envisaged approach. I urge you to take that opportunity.

Before I finish on the question of domestic regulation let me say a word about the important role that industry bodies can play in supporting good standards. I would like to commend IFIA and the funds industry more generally for rising to the challenge of developing its corporate governance code for fund service providers. This has helped raise standards in a pragmatic and sensible way. It has helped improve governance in the industry and provided a practical framework regarding the number of directors at funds. You will have noted that a leading funds jurisdiction was heavily and prominently criticised for its approach to multiple directorship. By tackling this issue head-on in its corporate governance code, IFIA has helped bolster the international reputation of the Irish fund sector. I should note that we will be revisiting our existing statutory codes for banks and insurance companies next year. We will use that process to review the success and take-up of the IFIA code. Also on the horizon, MIFID II will be coming into force before too long and will be prompting a reassessment of corporate governance standards for investment firms, which of course would include a number of fund service providers.

Authorisation

If the starting point of the regulatory model for funds is about getting the rulebook right – both in Europe and here in Ireland – it is equally important to get the process of reviewing fund applications right. I tend to get very good feedback from industry sources about the quality of our authorisation and approval process for funds, not just here in Dublin but when I speak to industry participants in London and New York as well.

But we think there is scope to get better yet. Mindful of industry expectations and also of the need to ensure an effective and efficient use of resources, the Central Bank regularly reassesses its internal processes and turnaround times for fund authorisations. However, in this area, we still rely extensively on manual processes and handling hard copies of documents. We want to move towards the receipt of information in electronic format. And we want to develop automated workflow processes to make us more efficient.

This is not just a matter of automating existing processes, but of challenging ourselves to ensure our process is as efficient as possible. We want to decompose the "as is" process for funds authorisation and rigorously assess it, challenging its individual component parts, before constructing our "to be" process under this re-engineering exercise. Our intention is to engage closely with industry and to seek your advice: tell us which aspects of the current process could work even better.

I caution that it will take a little time to implement these changes. We don't want to rush and destabilise the current platform which is working well. But we are committed to making improvements in efficiency without loss of effectiveness. These improvements go hand-in-hand with the introduction of online reporting by individual funds which we consulted on in June.

The industry itself can play its part in improving the authorisation process. Sometimes the quality of applications can be uneven and incomplete. At other times some stakeholders – often those highly inventive and over-exuberant lawyers – can test the boundaries of what is an acceptable interpretation of European law without giving sufficient consideration to the difficult legal and policy questions involved.

The funds industry continues to grow. Innovation is a key feature of its progress. Change is a positive driving force for all of us. While there will always be a natural tension between financial regulation and product innovation, the Central Bank is committed to proper and active engagement with industry to resolve issues. We regularly take stock of our approach, drawing on the output of quarterly meetings with IFIA, bi-lateral engagement with law firms and regular contact with fund promoters and investment managers at home and abroad. And we press matters with our colleagues in Europe when necessary.

Supervision

What then of our approach after authorisation, namely to supervision? In our view, the structure of the industry here in Ireland and the risks that it poses to the Central Bank's objectives means that the principal (but not exclusive) focus of our supervisory effort should be on the fund service providers. These are the management companies, fund administrators and custodians that are so important in ensuring the key elements of investor protection, such as accuracy of valuation and safeguarding of assets. Indeed, it is impractical (or at least prohibitively expensive) to have close supervisory engagement with all individual funds.

This supervisory model is reflected in our PRISM system, which is the new framework for risk-based supervision that the Central Bank has implemented for all firms operating in the Irish financial services sector. PRISM operates by calculating an impact categorisation of our more than 10,000 regulated entities to allow us to decide on the level of engagement and therefore resources we will apply to any individual firm. Under PRISM, fund service providers tend to have a higher impact categorisation, with more subsequent engagement from supervisors (and will therefore pay more). As part of the introduction of the PRISM process there have been a few structural changes in the way Supervision is operated by the Central Bank. On the ground, the differences you will note if your firm is in this category are more effective liaison with your direct supervisory team as well as more frequent on-site visits with yourselves by my staff. I will be asking my supervisors to look more closely at where those investor protection and financial stability risks I talked about earlier exist, including challenging assumptions that lie behind business models and strategies in the sector and the governance, systems and controls that underpin them.

In contrast, each individual fund, in itself, has a limited potential impact on financial stability and investors in the event of failure – and so, each of the more than 5,000 funds domiciled in this jurisdiction – cannot and should not expect the same level of supervisory engagement as afforded to the fund service providers. Our supervisory model, however, does provide capacity for us to react to triggers and problems that emerge in individual funds as well as random spot-checks. We will also increasingly rely on the use of our thematic supervisory tool, namely examining a specific issue across a cross-section of institutions.

Shadow banking

While individual funds may be low impact entities in our supervisory model, the funds industry is of course a high impact sector viewed collectively. This is not just a question of investor protection. Increasingly, the interest of the international regulatory community is directed at the level of systemic risk posed by particular parts of the funds industry, namely money market funds. The backdrop to this interest is the risk of investor runs on money market funds as a result of a threat of breaking the buck and the onward impact of such a run on the markets in which those money market funds are invested. As you are no doubt aware, this is clearly on the regulatory agenda at the G20, in IOSCO, at the European Commission and also in the US at the SEC. A few concluding thoughts on the regulatory agenda in this area.

My first high-level message, is that the industry in Ireland must be prepared for change. During the financial crisis, investor runs on MMFs led to a disruption in the flow of finance to the real economy and necessitated dramatic interventions by public financial authorities. The Central Bank believes that regulatory reform should focus on the need to reduce the probability of investor runs, to curb implicit support from sponsors and to reduce the need for support from the taxpayer.

In order to avoid disruptive industry shifts, my preference is for international alignment between Europe and the US in this area. It appears that the SEC will not be driving further regulatory reform in the short term. European action may be needed to drive matters forward. IOSCO also has an important role to play. But it is critically important that the U.S. perspective continues to be articulated and heard. The optimal outcome remains a shared perspective across the Atlantic on reducing the risk of runs in this sector and we must do everything we can to ensure that we can continue to move towards that goal.

What action should Europe take now? Market conditions in European Prime MMFs which are earning negative yields may pre-empt the conclusions of the FSB and other policy decision-makers. As you know, some promoters are contemplating new structures where investors earn negative returns. We should see how this plays out and in particular the investor response to the structures that the promoters offer. In the meantime, consultation exercises on this very question are well advanced and the Central Bank has actively engaged in this debate. Having regard for the experience of MMFs during the financial crisis and more importantly for the low risk appetite of MMF investors for capital losses, the Central Bank's view is that a mandatory switch from constant net asset value to variable net asset value does not adequately address the fundamental problem of ***whether*** an investor run on a money market fund may take place – though we would acknowledge it may affect the dynamic of that run.

Substantial reform can be achieved through a range of measures such as capital buffers, dilution levies for exiting investors and tighter liquidity measures. Indeed, it would appear that one of the recommendations of IOSCO – which was mandated by the FSB to look at MMFs as part of the Shadow Banking system – is to seek tighter rules on the liquidity of MMFs so as to ensure that there is enough liquidity to meet redemptions. It is worth noting that the SEC addressed this with their MMF reforms in 2010.

The other key issue exposed by the financial crisis was that investors expected sponsors to support MMFs where assets show excessive volatility to the downside. This in turn put pressure on the liquidity position of the sponsoring institution which was invariably a bank with access to a central bank liquidity window. Future reform of the MMF industry should ensure that any insurance that this "recourse to sponsor" provides is properly charged to MMF investors. In this regard, one of the other IOSCO recommendations is likely to be the mandatory requirement of gates as a redemption tool, which to our thinking would be sensible. Where support from a sponsor is implicit it should be made explicit, though it is worth acknowledging that this may have implications for the capital requirements of the sponsor.

Whatever the detail of the reforms for money market funds, change is coming and it will be significant. As I said, my key message is to engage in the debate and be prepared to adapt.

Conclusion

The more than 1.3 million investors who rely on the Irish fund sector highlight the need for robust standards of investor protection in our market. Funds may be different from other financial services sectors, but it is still vitally important to get the right regulatory framework in place so that investor protection is assured. This will improve the reputation of Ireland as an international financial services sector and support the success of the funds industry. There is an opportunity to re-examine the different elements of that regulatory framework for investor protection: the standards in place at a European level and domestic level, the processes the Central Bank uses to authorise new funds, the supervisory framework applied to the sector, and the emerging standards relating to Shadow Banking.

As I have explained, the Central Bank is committed to a level of high engagement with Europe in crafting that framework – and to rigorously reassessing our domestic framework, processes and supervisory approach. We would encourage IFIA and the Irish fund sector to play its part in this process by contributing to the regulatory dialogue at the European and Irish level, by offering constructive ideas to address the changing regulatory priorities of the post financial crisis world, and by maintaining high standards of practice in the Irish market that ensure a continued reputation for high standards of investor protection.