ADVISORY | INDUSTRY INFORMATION

Central Bank's Regulatory and Supervisory Outlook Report 2024 Key trends, risks and priorities facing funds and the asset management sector

On 29 February 2024, the Central Bank of Ireland (the "**Central Bank**") published a new Regulatory & Supervisory Outlook Report outlining the key trends and risks which the Central Bank has identified as moulding the financial sector operating landscape and its consequent regulatory and supervisory priorities for the next two years (2024/25) (the "**Report**"). The report was accompanied by a letter to the Minister for Finance and a subsequent cross-sectoral Dear CEO letter outlining a number of key regulatory initiatives for the year ahead (the "**Letter**"). The aim of the Report is to supplement the feedback provided by the Central Bank to regulated entities through its sector-specific supervisory engagement as well as its various consultative forums, conferences and publications. It also includes specific *Spotlight* chapters touching on areas of particular concern, such as consumer protection[1], artificial intelligence ("**AI**") and financial crime. The scope of the Report extends to internationally active regulated entities and the interests of their consumers and investors and is not limited to those segments of the financial sector associated with the domestic economy. While the scope of the Report is far reaching, we have sought to highlight those risks and supervisory priorities identified by the Central Bank, which are of most relevance for funds and their service providers.

Central Bank Consultation Paper (CP158) on the revision of its Consumer Protection Code

Key Themes and Risk Areas

In considering the global and domestic risk landscape of the various sectors covered by the Central Bank's remit, it has identified the following eleven key risk areas falling broadly under three thematic headings and each of which are interconnected:

Risk Theme A: Risks that are predominantly driven by the macroeconomic and geopolitical environment.	Risk Theme B: Risks that are predominantly driven by the way regulated entities operate and respond to the evolution of their marketplace and today's changing world.	Risk Theme C: Risks that are driven by the longer term structural forces at play.
Interest rate and inflation risks	Consumer and investor detriment risks	Climate and other environmental-related risks
Asset valuation and market risks	Operational risks and resilience	Financial crime risks
Liquidity and leverage risks	Risk management practices and risk transfer	Strategic risks
Credit and counterparty risks	Data deficiencies and modelling risks	

1 Central Bank Consultation Paper (CP158) on the revision of its Consumer Protection Code

Specific Focus on those Risk Areas of relevance to Funds sector

The headline sectoral risks and trends identified by the Central Bank for the Funds and Securities Market sector are largely consistent with the supervisory priorities for the sector listed in last year's Securities Markets Risk Outlook Report 2023. We have sought to summarise the key points of relevance for the sector below.

Leverage and liquidity

Driven by the current macroeconomic climate and inadequate liquidity risk management frameworks within some firms[2], the Central Bank has noted that issues with liquidity in open-ended funds could have systemic implications and result in investor protection concerns.

The Central Bank has highlighted the following specific concerns relating to leverage and liquidity within the funds sector:

- the effects of rapid deleveraging;
- synthetic leverage obtained via derivatives;
- liquidity mismatches and forced asset sales;
- valuation issues, particularly involving less liquid assets; and
- the interconnection with other significant financial sectors including, banking, pensions and insurance.

Market Integrity

Those funds and their service providers subject to the Market Abuse Regulation should, in particular, take note of the Central Bank's expectations in terms of oversight and controls of high frequency/algorithmic trading and market manipulation (including cross-venue and posting investment recommendations on social media). Such firms should have in place appropriately calibrated surveillance systems to monitor and detect potentially abusive practices.

Conflicts of Interest

The Central Bank has noted that shortcomings have been observed recently in how relationships between related parties are managed and connected party transactions are carried out which can lead firms and/or their employees to prioritise their own interests over the interests of their clients or others.

The Central Bank notes that transactions between related parties are common in fund structures, for example, where a depositary provides a number of services to various Irish authorised funds, and that potential conflicts of interest must be carefully governed by firms

Delegation and Outsourcing

The Central Bank has noted that weaknesses in delegation models, especially for funds, can lead to delegation and outsourcing risks.

It highlights in particular the current focus on the activities of 'white label' fund management companies ("**FMC**"), being those FMCs that provide a platform to business partners by setting up funds at the initiative of the latter. The Central Bank notes that it has observed a lack of oversight and scrutiny by such FMCs of their business partners' structures where such business partners have been appointed investment manager.

Sustainable finance

The Central Bank notes that ESMA's common supervisory action ("**CSA**") on sustainability and disclosure risk was launched with the aim of investigating compliance with sustainability and disclosure requirements.

The Central Bank also acknowledges that many FMCs are unable to obtain sufficient data on the sustainability of their own investments leading to a risk that investors are being inadequately informed or potentially misled as a result.

While greenwashing continues to be a risk associated with sustainable finance, the Central Bank has now identified "green bleaching" as a new risk which it has observed in the funds industry and which can occur where an FMC does not want to risk non-compliance with the more onerous requirements of Article 9 of the Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector ("**SFDR**") and instead decides to categorise funds under its management as falling under Article 8 or 6 of the SFDR.

Data Quality

The Central Bank has noted that the quality of fund data it receives remains concerning with firms not adequately overseeing the accuracy of their data thus negatively impacting the management of firms and understanding of market positions and exposures. Poor data quality can also potentially result in investors being provided with inaccurate information.

Cybersecurity

The Central Bank notes that cyber-attacks continue to pose a threat with the increased use of AI and Fintech, more home working and geopolitical tensions all contributory factors.

AI and Fintech

While the use of AI and Fintech has great potential for bringing positive changes and improved efficiencies to all financial sectors, the Central Bank has noted that it may also result in creating or amplifying certain risks. Such risks may also interlink with other risk areas such as cybersecurity and market integrity.

The Central Bank has indicated that it will be looking ahead to the new proposed EU Regulation on laying down harmonised rules on AI and amending certain Union legislative acts COM(2021) 206 final (the "**AI Act**") and its application by firms.

External risk environment

The Central Bank notes that firms must be financially resilient and mitigate the key exposures from their external environments. It expects firms to carry out assessments of resilience including severe but plausible stress testing and performance analysis.

The Central Bank highlights, in particular (i) concentration risk potentially resulting in a knock on impact to Irish firms from failing international firms and (ii) highly leveraged funds and firms managing portfolios of assets sensitive to interest rate changes being potentially disproportionately affected by the impact of rising interest rates and inflation.

2 In the Report the terms "regulated entities" and "firms" are used interchangeably.

Key Supervisory Priorities

Set against the current macro environment and risk landscape, the Central Bank has identified the following key supervisory priorities that reflect the outcomes sought by the Central Bank in order to enable it to achieve its statutory mandate and responsibilities:

Supervisory Priority 1	**Supervisory Priority 2**	**Supervisory Priority 3**	**Supervisory Priority 4**	**Supervisory Priority 5**	**Supervisory Priority 6**
Proactive and consumer-centric leadership of firms	Firms are resilient	Firms address operating framework deficiencies	Firms manage change effectively	Climate change and Net Zero transition are addressed	The Central Bank enhances how it regulates and supervises

Key Supervisory Priorities for 2024/25 for the Funds sector

The Central Bank has identified in particular the following as its key supervisory priorities of most relevance to funds:

- Risk-based scrutiny and approval of prospectus applications, fund applications and regulated fund service provider ("**RFSP**") applications;
- Participation in ESMA's Depositary Peer Review;
- Sectoral/thematic assessments, including the completion of the ESMA CSA on the SFDR;
- Further development of an understanding of the use of AI and related governance processes from a conduct perspective, in particular for trading activities and corresponding opportunities and/or potential negative impacts on market integrity; and
- Continuing to enhance the capacity to identify and pursue instances of market abuse.

Spotlight on AI

The Report also includes three *Spotlight* chapters covering consumer protection, AI and financial crime.

Given its wide application to all sectors, AI is one of the technologies with the greatest transformative potential for the entities the Central Bank supervises and for the Central Bank itself as a regulator. In parallel with other large organisations, the Central Bank will be exploring and trialling how the deployment of the latest AI tools could assist it in optimising the use of its finite resources and in providing insights from the large data sources it has available as it seeks to continually enhance its supervisory effectiveness.

The Central Bank highlighted that it will be undertaking policy work and developing its supervisory expectations of regulated entities related to the use of AI in financial services, including preparing for the implementation of the AI Act. The Central Bank will seek to understand how firms are using AI to deliver and support existing financial services, as well as consideration of how AI could be used for new products, services, and business models.

Key Regulatory Initiatives

The key regulatory developments for 2024 identified by the Central Bank include at a domestic level:

- implementing the **Individual Accountability Framework (IAF);**
- working with the Department of Finance on priority policy areas including the completion of the **2030 Funds Review;**
- continuing to progress its work both internationally and domestically to address systemic risks from the non-bank sector in light of macro-prudential risks in this sector;
- the **AI Act** which is expected to enter into force in the coming months;
- the new **Anti-Money Laundering (AML) legislative package** and the establishment of an EU AML Authority;
- the implementation of the **Digital Operational Resilience Act (DORA)** which will apply in full from 17 January 2025 and which the Central Bank notes includes similarities with the existing Central Bank guidance in relation to Outsourcing, Operational Resilience and IT & Cybersecurity Risks, as well as existing sectoral guidelines; and
- the **Retail Investment Strategy**, which could result in significant changes to the current regulatory landscape and is currently undergoing review at EU Council level.

Next Steps

These recent publications from the Central Bank provide a helpful overview for boards and officers of funds, their service providers and other market participants as they navigate the regulatory year ahead. It is clear that the Central Bank expects a demonstration of clear leadership on greenwashing as well as leverage/liquidity with robust governance processes and ensuring that business models remain operationally resilient.

It would be prudent for RFSP's to align with the Central Bank's expectations by ensuring that the risks and supervisory priorities outlined in the Letter and the Report respectively are monitored and addressed in their firm's horizon planning, risk assessment and risk mitigation programmes. Walkers will continue to keep client firms and boards appraised of developments in the Central Bank's identified regulatory and supervisory priorities on an ongoing basis.

Key Contacts

If you have any queries on the content of this advisory and/or the impact that it may have on you and your business, please speak to your usual contact in Walkers or connect with.

Further information

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