Outcome of Central Bank of Ireland CP86 Thematic Inspection

On 20 October 2020, the Central Bank of Ireland (“**Central Bank**”) issued a Dear Chair letter outlining its findings following a thematic review assessing how fund management companies (“**FMCs**”) have implemented the Central Bank’s requirements and related guidance on the organisation of FMCs. The Central Bank has identified a number of areas where compliance with the requirements and guidance needs to be further assessed by FMC boards, particularly in relation to resourcing of FMCs that were authorised before the new FMC framework was introduced (in 2017 for firms seeking new authorisation and mid-2018 for existing firms).

The Central Bank requires all FMCs, whether or not they receive a specific risk mitigation programme from the Central Bank, to critically assess their day to day operational, resourcing and governance arrangements against all relevant rules and guidance, taking into account the findings of the Central Bank’s review. The Central Bank states that the FMC’s analysis should be completed and an action plan discussed and approved by the board by **end Q1 2021**.

Background

Following a detailed consultation process, the Central Bank’s Guidance for Fund Management Companies was published in December 2016 and related changes were made to the Central Bank rules applicable to the effective governance, management and organisation of FMCs. These rules and the guidance form the Central Bank’s FMC framework, which detail the standards that apply across a range of aspects of fund management company activities including: organisational effectiveness, the performance of managerial functions, delegate oversight, resourcing, etc. As noted above, the new FMC framework applied to FMCs seeking new authorisation in 2017 and to existing FMCs in mid-2018.

When it published its FMC guidance, the Central Bank indicated that it would conduct a thematic inspection of the implementation of the guidance and rules shortly after the introduction of the new framework. This thematic inspection was conducted over the latter half of 2019 and in early 2020, consisting of three phases comprised of an industry questionnaire, a desk-based review and culminating with onsite reviews. The review covered all 358 active FMCs and included 30 onsite engagement meetings held between December 2019 and March 2020.

The Key Findings

The Dear Chair letter was accompanied by a three-page document setting out the high level findings of the thematic review. The findings and expectations set out in the letter and the accompanying document are set out in the table below.

Overall Findings	▪ When applied correctly by FMCs, the rules and guidance provide a framework of robust governance, management and oversight arrangements. ▪ The review evidenced that some FMCs were able to demonstrate that they were largely compliant with the framework and met the Central Bank’s expectations in many respects. ▪ A significant number of previously authorised FMCs have not yet fully implemented the framework. Many were able to evidence the introduction of only limited changes following the implementation of the FMC framework.
Resourcing	*Findings* ▪ Many FMCs authorised before the framework was introduced do not have the appropriate levels of resources in place to ensure effective implementation of the framework. ▪ The Central Bank is satisfied that the application of the framework to the authorisation of firms following its introduction in 2017 has resulted in appropriate and effective levels of resourcing of those firms. However, the review highlighted material divergences from this resourcing standard in firms who authorisation pre-dated the framework coming into force. ▪ The Central Bank found that time commitments of Designated Persons, and more generally, resourcing levels were below Central Bank expectations. ▪ The review identified co-mingling of support staff working within both the investment management and risk management functions. *Expectations* ▪ FMCs must be able to demonstrate ongoing and effective management of all activities, including high quality and effective oversight of those activities performed by delegates. ▪ FMCs must be able to demonstrate that their governance structure, including its entity-specific second line of defence, is sufficiently resourced to achieve this. Over-reliance on group entities and / or delegates can result in deficiencies in the legal entity-specific second line of defence. ▪ All FMCs should have a minimum of three suitably qualified and appropriately senior full time equivalents (“**FTE**”). ▪ FMCs must appoint locally based persons who conduct managerial functions (Designated Persons). For larger firms, Designated Persons are expected to be full time roles. ▪ FMCs should have a formally documented succession plan.
Designated Persons	*Findings* ▪ The level of review carried out on monthly reports received from delegates, the independent analysis of those reports and ultimately the quality of the information provided by the Designated Person to the board were deficient. The review identified poor quality reporting received from delegates. ▪ The review identified varying levels of independent verification performed by the Designated Person. *Expectations* ▪ The Central Bank will look for evidence of constructive challenge by Designated Persons and interrogation by them of information received from other FMC staff and delegates. ▪ Designated Persons should be able to clearly evidence the value they bring to their oversight role through documented board reporting. ▪ There should be clearly defined thresholds / criteria for escalation of issues to the board.
Delegate Oversight	*Findings* ▪ Some firms were unable to evidence that they had carried out the appropriate level of due diligence on their delegates, both upon appointment and on an ongoing basis. ▪ There were many cases where there was a lack of effective engagement with delegated investment managers. This was particularly significant where there was a high number of appointed investment managers. FMCs should be able to evidence challenge to the delegate investment manager. *Expectations* ▪ Where reliance is placed on policies and procedures of delegates / group, FMCs must be able to demonstrate that they have reviewed and approved delegate / group policies and procedures as being fit for purpose when applied to the firm. FMCs should have a formalised process to review all delegates’ policies and procedures. ▪ Due diligence reviews should be conducted by the FMC upon appointment of the delegate and annually after appointment. ▪ All delegate arrangements should be governed by way of formally documented service level agreements.

Risk Management Framework	*Findings*
	In many cases, there is an over-reliance on group frameworks.
	Expectations
	▪ FMCs should have in place an entity-specific:
	  ▪ risk management framework;
	  ▪ risk register; and
	  ▪ risk appetite statement.

Board Approval of New Funds	The Central Bank is critical of situations where board approval of the investment fund / strategy is obtained just prior to launch. The Central Bank expects evidence of robust discussion and challenge by the board in relation to proposed new fund strategies / structures and their attendant risks. The board should be involved early in the process eg, when first formulating the investment strategy or prior to the submission of a fund application to the Central Bank.

Organisational Effectiveness Director	*Findings*
	▪ The Central Bank identified a number of weaknesses in how the organisational effectiveness director role (“**OED**”) was being carried out in a large number of FMCs. These included:
	  ▪ an inability to evidence that meetings were conducted;
	  ▪ no formal record of meetings with Designated Persons (interactions between the OED and Designated Persons should be at least quarterly);
	  ▪ failure to provide evidence that consideration had been given to conflicts of interest and personal transactions; and
	  ▪ an absence of formal reporting to the board.
	Expectations
	▪ The Central Bank emphasises in particular the area of resource evaluation in relation to board reporting. OEDs should be able to evidence how they reached a conclusion that resourcing levels within the FMC were adequate.
	▪ The OED should ensure that a documented board effectiveness evaluation is conducted on an annual basis, including findings and time specific actions.

Governance and Culture	*Findings* ▪ The vast majority of FMCs have not appointed a CEO. ▪ The review found that two-thirds of FMCs have at least one Independent Non-Executive Directive (“**INED**”) with a tenure of greater than five years, while 28% have at least one INED with a tenure of greater than 10 years. ▪ There is a significant gender imbalance on the boards of FMCs. Only 16% of director roles are held by women. ▪ The Central Bank found that minutes were insufficiently detailed to capture the discussion or challenge at board level. *Expectations* ▪ The Central Bank expects that all but the smallest FMCs should have a CEO. ▪ Tenure and ongoing independence should be considered as part of the OED’s review of board composition. Such review should consider the appropriateness of the continued use of INED designation where the INED is in place for such a prolonged period of time. The review should consider how to achieve a sufficiently regular rotation of board members to ensure independent challenge at board level. ▪ Boards should conduct formally documented reviews of: (i) board performance; (ii) board composition; and (iii) INED tenure. ▪ FMCs should consider gender diversity as part of the governance review required by the Dear Chair letter. ▪ Boards should have in place board-specific Terms of Reference.

Next Steps

The Central Bank has commenced supervisory engagement with FMCs where specific concerns have been identified. This will result in risk mitigation programmes for “many firms”, according to the Central Bank. It also states that findings from the review will inform its consideration of policy development and potential future enhancements to the existing regulatory framework.

Whether or not FMCs receive a risk mitigation programme from the Central Bank, all firms must carry out an assessment and put in place an implementation plan, which must be discussed and approved by the board by the end of Q1 2021. The Central Bank’s letter states that this assessment and implementation plan should at a minimum consider the following:

- the time commitment, skills and expertise of available resources;
- the FMC’s retained and delegated tasks, including how ongoing independent challenge of all delegates can be ensured;
- the tasks required by the framework, including those that must be completed on a fund by fund basis;
- how resources and operational capacity will need to increase to take account of any increase in the nature, scale and complexity of the funds under management since authorisation or the last time the FMC critically assessed its operations; and
- how resources and operational capacity will need to increase to deal with a market and / or operational crisis.

The Central Bank has also indicated that it plans to conduct a further industry wide review of these matters in 2022 to assess FMC’s actions on foot of the findings set out in the Dear Chair letter.

Comment

The Central Bank’s conclusion that, when applied correctly by FMCs, the rules and guidance provide a framework of robust governance, management and oversight arrangements is welcome. While the review may inform future policy developments and future enhancements of the FMC framework, the review findings would suggest that the framework is robust and credible and not in need of substantial change. It is also positive that there was a high level of compliance among the significant number of recently authorised FMCs (many of which were Brexit-related applications).

It is noteworthy that, in some respects, the Central Bank’s expectations as outlined in the letter go beyond the current FMC guidance, such as the Central Bank’s focus on board diversity (which has, however, been addressed in several Central Bank speeches), the requirement for all but the smallest FMCs to have a CEO and scrutiny of the independence of INEDs with a tenure of longer than five years. Further clarification from the Central Bank regarding the reference in the Dear Chair letter to Designated Persons being “locally based” and how this aligns with the Central Bank’s “location rule”, which requires that half of managerial functions must be performed by at least two persons resident in the EEA, would be welcome to assist FMCs in assessing their governance arrangements.

The Central Bank’s particular focus on resourcing and the requirement to have three FTEs will have to be carefully considered by self-managed and internally managed funds, which may have to consider measures including increasing the time commitments of designated persons, hiring full-time or part-time, establishing an Irish management company or appointing an external management company in order to meet the Central Bank’s expectations on resourcing and governance.

All FMCs, but particularly those authorised before the introduction of the FMC regime, should take steps immediately to carry out the necessary assessment and put in place the board-approved action plan by end Q1 2021. While the Central Bank has indicated that it will conduct a further industry wide review of implementation in 2022, it is likely that FMCs will see the Central Bank’s expectations as set out in the Dear Chair letter being applied in advance of that review in the context of any new Designated Person or other pre-approval controlled function appointments and in any meetings with the Central Bank as part of their regular PRISM engagement.

Please get in touch with your usual Asset Management and Investment Funds Department contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this briefing note.

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