THE INVESTMENT ASSOCIATION

Response to consultation

EU COMMISSION CONSULTATION ON MACROPRUDENTIAL POLICY FOR NON-BANK FINANCIAL INTERMEDIARIES

Response submitted the European Commission online on 22 November 2024, with Executive Summary, reference notes and any parts of questions included in an attachment

About the Investment Association

The Investment Association (the IA) champions the interests of the UK-based investment management industry. We represent 250 investment managers, a third of whom are headquartered in the EU. Collectively, they operate from 642 offices across the EU and have more than 2,100 funds domiciled in the EU.

Our members put €10.6 trillion to work in the global economy, representing 37% of the €28.6 trillion in assets managed in Europe. They manage €2.5 trillion for European savers and invested €843 billion into EU businesses and projects last year while providing access to global investment opportunities.

Our mission is to make investing better. Better for our clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

Background comments and executive summary

The IA welcomes the opportunity to respond to this consultation concerning a possible macroprudential framework for Non-bank Financial Intermediaries (NBFI). We share the Commission's objective of ensuring the NBFI sector is resilient, of which regulated investment funds are a smaller subset. Significant work has recently been conducted through the AIFMD and UCITS review with this objective in mind, and we welcome the opportunity to comment further.

As per the EU's Better Regulation Principles, any policy interventions, if indeed they are to be pursued by the Commission, must be balanced, proportionate, and evidence-based. We welcome the Commission's nuanced approach in this consultation by considering **unmitigated** liquidity mismatch and **excess** leverage, as opposed to assuming that liquidity variances or leverage are inherently systemic risks. Nonetheless, in our response below we challenge several of the fundamental assumptions that feature in the Commission's assessment, alongside other policy publications from international policymakers.

Firstly, the assumption is that all NBFIs should be considered a single, distinct sector compared with the banking sector. This oversimplifies the significant differences between different constituencies of NBFIs,

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particularly when considering the varied nature of their business model, client base, service offering, extent of regulation, and degree of supervision. As John Schindler, Secretary General of the Financial Stability Board (FSB), put it in a recent speech, "calling it the non-bank sector may have been appropriate for a while, but the time has come to stop referring to it as if it is monolithic"[1]. The diversity of the NBFI sector must be a starting point when considering any policy intervention.

Furthermore, it implies that risks observed in market-based activity arise only from the NBFI sector rather than potentially emanating from, or being exacerbated by, other parts of the financial system or the interaction of different entities in specific market contexts. Recent notable failures, such as the collapse of Silicon Valley Bank (SVB) and the near failure/rescue of Credit Suisse, should remain critical touchpoints in any debate about financial stability. So, too, should the relative performance of EU Money Market Funds in 2020 and other liquidity events since, which have helped to demonstrate, in real-time, the resilience of the current EU regulatory framework for investment funds. For macroprudential policy to be effective, a system-wide consideration is needed of banks and NBFIs together rather than assessing NBFIs singularly.

Secondly, the risks presented as grounds for policy intervention are often conceptual rather than based on evidence. We understand the suggestion that regulators need to prepare for and be able to respond to potential new risks in the system rather than being unduly constrained by specific lessons from previous crises. However, the starting point for this discussion must be rooted fundamentally in the available evidence base and the nature of the activities under scrutiny.

We believe insufficient evidence has been provided to meet the proportionality threshold warranting policy intervention. The literature on the subject has too often failed to make the case for real financial stability risk – the possibility of an event threatening the function of the broader financial system or the real economy[2]. Market volatility alone should not be cited as evidence of systemic risk. Financial markets, whether formal trading venues such as recognised exchanges or less formal, such as "Over-the-Counter" (OTC) bilateral trading, are price discovery and exchange mechanisms where the price of assets fluctuate driven by supply and demand, regardless of the circumstances where these arise.

Thirdly, for asset managers and asset management products, such as investment funds, the agency role of asset managers is critical when assessing any systemic risk posed by this sector. Asset managers are not managing their own money – this is money entrusted to them by investors. While individual securities allocation decisions are typically made by asset managers, the decisions on whether to enter or exit markets are frequently not – they will, in most cases, reflect the decisions of the end investors. Where they can meet redemption requests without (in the case of a fund) harming the interests of other investors, they are under an obligation to meet these redemption requests – it is not for the asset manager in this scenario to take a view on whether it is a good time for the investor to exit the market. As such, this mirrors rather than amplifies the allocation decisions being taken by investors across the market as a whole.

Additionally, the assets managed are segregated from asset managers' own balance sheets and those of other investors. The segregation of assets is a feature that significantly limits the possibility of transmitting risks to other entities. Segregation acts as a firebreak.

Fourthly, we agree with the Commission's conclusion in its 2023 report that it is unnecessary to fundamentally revisit the Money Market Fund (MMF) Regulation. As the Commission's report explored in detail, European MMFs proved their resilience in the face of considerable outflows in the March 2020 Covid and the September 2022 UK gilt market stresses. We agree that a small number of enhancements could be made to the framework via targeted amendments, such as removing the regulatory link between breaching

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[1] Building bridges: the case for better data and coordination for the non-bank sector: Speech by John Schindler, Secretary General of the Financial Stability Board, at the Eurofi Financial Forum 2024 in Budapest, 12 September 2024

[2] This is in line with the definitions used by global policy makers. In their 2009 joint report to the G20, the FSB, IMF and BIS define systemic risk as "a risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy." (Guidance to Assess the Systemic Importance Financial Institutions, Markets and Instruments: Initial Considerations, Oct 2009)

liquidity thresholds and activating liquidity management tools and removing restrictions around the use of government securities in liquidity thresholds.

However, some of the reforms proposed, particularly giving EU bodies and NCAs the power to increase liquid asset thresholds for certain MMFs or during stressed periods, could negatively impact the resilience of MMFs and destabilise Short-Term Funding Markets (STFMs). Greater focus is instead needed on improving the functioning, efficiency, transparency and diversity of participation in STFMs, and we welcome considering these in this consultation.

We do not consider that group wide stress tests should be imposed on investment management firms. Such tests are only relevant to entities that carry balance sheet risk. As investment management uses an agency-based model, where assets are segregated from those of the manager, other products and mandates, investment managers do not typically carry any material balance sheet risk, making group stress tests meaningless. We also do not believe that stress testing of products at a group level in most cases is likely to yield any meaningful results, given that even similar funds can experience market challenges in different ways, depending on factors such as their respective investor bases.

Finally, while we do not offer a view on how the EU's supervisory responsibilities should be assigned between national regulators and EU bodies such as the ESAs, we emphasise the importance of ensuring a consistent and coherent approach to supervision reflecting a common regulatory framework. In this context, we also emphasise that asset managers are best placed, having the best understanding of their products, portfolio characteristics, investor base and the trading environment they are experiencing, to make informed decisions on appropriate interventions in response to stressed events and interventions by NCAs and/or EU bodies should only be on an exceptional basis.

Chapter 1: Key Vulnerabilities and Risks Stemming from NBFI

Please consider how the question applies to different NBFI sectors (entities and markets) and specify the NBFI sectors concerned when providing a response. Please also provide quantitative evidence, where possible.

Question 1. Are there other sources of systemic risks or vulnerabilities stemming from NBFIs' activities and their interconnectedness, including activity through capital markets, that have not been identified in this paper?

The systemic risks identified appear directed to a significant extent at the asset management industry, and less focus is given in the paper on systemic risks that may arise elsewhere within the financial system. We welcome the nuances the Commission includes, particularly the reference to "unmitigated" liquidity mismatch and "excess" leverage, which recognise existing tools deployed by NBFIs, especially in asset management. We regard "excess leverage" as leverage that is unreported and unsafe, ie not properly managed, rather than this being a function of the size of the leverage. We consider that the critical aspect is to make sure that in any case leverage is reported to regulators, as it is required for instance for each non-UCITS fund (i.e. AIF fund) in the context of the AIFM Directive.

In considering whether a risk is systemic, it is essential to differentiate between events that impact only the entity and its customers/investors, and those that cause a significant and widespread impact on other parts of the overall financial system or the real economy. An investment fund that encounters liquidity challenges and cannot meet redemptions is an example of the realisation of unmitigated liquidity mismatch risks.

However, it should only be considered systemic if it had a broader impact on other parts of the financial system, such as leading to a run on withdrawals from other investment funds. This has not proved to be the case historically. For example, the suspensions of the Woodford Equity Income Fund in the UK and the H2O funds in Luxembourg/France in 2019 did not result in any runs on other funds. Notably, while these heavily impacted the investors in those funds, these impacts were contained and no contagion effects were observed in the wider market.

Furthermore, a system-wide view of the impact of all system participants, the relative risks they pose, and the mitigants appropriate for those participants must be taken. We do not agree that it is helpful to consider banking and NBFI separately when considering financial stability. An alternative approach would be to identify and investigate areas where systemic risks have been observed and consider how best these can be addressed across any given market or market areas using an evidence-based approach to inform policy responses.

There are some risks not specifically mentioned in the consultation, which in our view warrant further investigation. These apply to all market participants, not just NBFIs. This is not to say that these definitively represent systemic risks – more exploration is needed to establish whether they do. Such risks might include:

- Concentration – This can arise when a market is dominated by similar investor types with similar strategies, leading to one-sided markets where participants tend to trade in the same direction. The UK's long-term gilt markets, which are heavily dominated by UK-defined benefit schemes using Liability Driven Investment Strategies, are an example of this.

- Cybersecurity—Cybersecurity breaches can compromise several market participants, impacting their activities, ability to provide services to other market participants, and settlement obligations and other liabilities, to other market participants, putting the latter at financial risk.

- Technology/infrastructure failures – widespread market disruption can arise from the failure of critical systems, e.g. the failure of a payments system can result in settlement failures, and in the event of a participant needing the payment to meet liabilities to other counterparties could result in wider failures.

- Algorithmic trading/AI—“Fat finger” manual input errors can be compounded by algorithmic/automated trading. These have destabilised markets, though the effects tend to be short-term with limited long-term damage.

The diversity of the NBFI sector is such that it includes entities that are subject to varying regulatory standards. For example, it not only consists of those such as insurance, pensions, asset management and investment funds that are highly regulated, but also those subject to little to no regulation, such as family offices and Sovereign Wealth Funds. Those entities that are regulated are already subject to high standards of oversight, intended to address a range of risks which are financial and operational in nature. They are subject to strict requirements on risk management frameworks, which are subject to scrutiny by regulators. These firms already, therefore, have significant mitigants in place that contribute to managing and containing the risks identified, which we explore in our responses to subsequent questions.

Question 2. What are the most significant risks for credit institutions stemming from their exposures to NBFIs that you are currently observing? Please provide concrete examples.

It is not meaningful to consider the potential risks to banks (credit institutions) stemming from their exposure to NBFIs without understanding the significant divergences between different sectors within NBFI, which will inevitably impact on the risks of different sectors to banks. The NBFI category is broad, and it is essential to recognise the implications of key differences between institutions falling within this category and structural differences between banks and NBFIs. Some entities within the NBFI sector are heavily regulated, such as asset managers, insurers, pension schemes and investment funds. These are subject to strict risk management requirements, report information to regulators, set strict internal risk limits, and, in the case of regulated products, are also subject to regulatory risk exposure limits.

Asset managers, in particular, are subject to strict asset segregation requirements, meaning their clients are not exposed to the asset manager's balance sheet risks. Investment funds are also subject to strict asset segregation requirements, diversification, and risk exposure limits—assets are ring-fenced from those of the manager and other investment funds. This is very different from other NBFI sectors subject to little to no regulation and for which regulators have little visibility over their activities. Notably, Archegos, whose collapse in 2021 resulted in losses for several banking institutions, was established as a family office and, therefore, was not a regulated entity.

By their nature, banks face risk from their activities with counterparties, which typically involve them providing credit or assuming risk exposures via derivatives. In both cases, the default by the counterparty can result in significant losses to the bank – loans are issued against the capital entrusted to the bank, and derivatives positions offered to clients are typically hedged in the market or against positions offered to other clients – a failure to honour the derivatives contract or meet margin payments by one counterparty affects the bank’s ability to meet obligations on other contracts.

Robust credit risk assessments on all counterparties are essential to the mitigation of credit risk of banks, including the availability of information relating to, and the reliability of the counterparty. Regulated entities will generally represent a lower credit risk for banks, as regulators already monitor and supervise their activities and risk positions. This contrasts with unregulated counterparties, which are not supervised and on which regulators need more information. Consequently, risks are likely to be higher where counterparties are unregulated, and this is where there should be a higher focus on understanding the activities, capital resources, and risks of those counterparties.

The distinction between regulated and non-regulated NBFIs must be considered when analysing the risk to banks. The IA does not consider it appropriate to seek to control risks to banks by placing additional restrictions on the activities of regulated NBFIs, whose activities are already subject to regulatory limits, along with supervision and monitoring by regulators. For asset managers (as well as for many other regulated NBFIs), derivative transactions are often undertaken to limit risks in the portfolios they manage for clients or investment funds or to efficiently gain exposure consistent with market risk (i.e. on a delta-one basis). Placing overly onerous barriers on the ability of regulated NBFIs to enter into these transactions would ultimately harm end clients and potentially leave them exposed to higher portfolio risks.

It ultimately falls on banks to be responsible for their counterparty risk management processes and ensure they do not take inappropriate risk exposures with individual counterparties. Any shortcomings in these processes must be addressed by the banks themselves rather than restrictions on NBFIs, where necessary, strengthening governance to ensure that sound risk management decisions on limiting exposure to high-risk counterparties, particularly those that are unregulated, are not overridden by commercial considerations. Overall, we welcome the proposal by the Basel Committee on Banking Supervision (BCBS) to update its Guidelines for Counterparty Credit Risk Management[3], while noting the differences between regulated and unregulated entity counterparties may be a relevant consideration by banks.

To be able to undertake sound counterparty credit risk assessments, banks must have appropriate transparency over their counterparties, including access to timely, frequent and accurate financial information on their activities and balance sheet strength. This is particularly important where counterparties are unregulated, as they are not subject to a regulatory framework and supervisory scrutiny on their activities. We encourage EU bodies and national governments to work with banks and their associations to identify and remove any legislative barriers that exist to banks receiving this information.

It should also be emphasised that failures in the banking sector disrupt the provision of critical services to NBFIs along with other commercial and individual customers. Silicon Valley Bank's (SVB) failure in March 2023 impacted venture capital and private equity investments in the technology sector. The near collapse

[3] Consultation on Guidelines for counterparty credit risk management issued by the BCBS, April 2024

and subsequent rescue of Credit Suisse, also in March 2023 (in part due to a loss of confidence following both the collapse of SVB and previous losses incurred in the Archegos default) resulted in broader concerns to holders of other AT1 (contingent convertible) securities, given the more favourable treatment of equity holders over AT1 holders by the Swiss National Bank. This inverted the normal creditor order and, therefore, changed the risk calculation for asset managers holding AT1 securities. Had other central banks not acted quickly to reassure investors of the normal creditor order for AT1 securities in the EU and other jurisdictions, this could have resulted in less investment in AT1s and therefore a capital funding challenge for banks. This point to maintaining investor protection being additive to financial stability, rather than a competing consideration, suggesting a more holistic consideration being required when considering the risks to the financial system, rather than separating NBFIs and banks, or only considering risks posed to banks by NBFIs.

Question 3. To what extent could the failure of an NBFI affect the provision of critical functions to the real economy or the financial system that cannot easily be replaced? Please explain in particular to which NBFI sector, part of the financial system and critical function you refer to, and if and how you believe such knock-on effect could be mitigated.

There is little evidence that the failure of an asset manager would result in any significant impact on the provision of critical functions in the real economy. Indeed, the UK has seen the failure of significant asset managers, including Barings Asset Management due to the collapse of its parent, Barings Bank (notably Barings Asset Management, which was subsequently acquired by a new owner following its insolvency, is the only Barings entity remaining today) and New Star Asset Management.

In both cases, the impact on investors was minimal – these were transferred to or absorbed by new owners, who were able to keep their investment funds going for investors. This is primarily due to a key structural feature of asset managers – lack of balance sheet risk. Asset managers act as agents for their investors. The assets they manage are segregated from those of investors, whether in a segregated mandate (held in custody accounts in the name of the investor) or in an investment fund, the assets of which are held by the depositary or its appointed custodian, with entitlement to investors represented by shares in the fund.

We explore the effects of this in more detail in our response to question 52 (below).

Question 4. Where in the NBFI sectors could systemic liquidity risk most likely materialise and how? Which specific transmission channels of liquidity risk would be most relevant for NBFI? Please provide concrete examples.

Liquidity risk is a significant risk for investors to consider, along with asset managers of products with redemption obligations, such as authorised funds. Increasingly, NBFIs using derivatives, such as asset managers, investment funds, and pension funds, also need to consider liquidity demands arising from non-redemption obligations, particularly the ability to meet margin calls. Liquidity in some markets can be dynamic, particularly in fixed income markets where secondary trading activity can vary.

From a systemic perspective, liquidity stress dynamics have been observed more in non-redemption liabilities, particularly margin calls. The move to central clearing following the Global Financial Crisis (GFC) of 2008, and the strengthening of collateral requirements for non-cleared derivative transactions, have undoubtedly reduced counterparty risks arising from derivative transactions. This though has been at the price of increasing liquidity risks across the market, since collateral is typically provided in cash, particularly for cleared transactions. This means in the event of an unexpected market call, asset managers are typically obliged to sell assets to raise cash to meet margin calls. Given that higher margin calls tend to arise during periods of high market volatility, these effects are generally pro-cyclical – they have the effect of amplifying price volatility and liquidity constraints during periods of market stresses.

We recommend that the European Commission and other EU bodies, alongside global policy makers, consider measures that will reduce the liquidity pressures that arise from margin calls while retaining the benefits of the reduction in counterparty risk, which could include:

Allowing a greater range of assets to be used as collateral under transfer or (preferably) pledge arrangements. The IA welcomes the initiatives of some Central Clearing Counterparties (CCPs) to operationalise the use of a wider range of assets to be used as collateral for initial margin, and encourages further regulatory and operational development in this area.

Amending the restrictions in the 2014 ESMA Guidelines on ETFs and Other UCITS Issues, which limits the use of cash collateral and effectively prevents UCITS management companies from being able to use repurchase agreements to transform assets to cash to post as margin, requiring them instead to sell assets.

Increasing the transparency around the methodologies of margin calculations by CCPs and non-cleared counterparties, enabling managers to better calculate and stress test the likely liquidity demands that would arise from margin calls in a stressed scenario.

However, from a systemic risk perspective, liquidity risk arising from redemption pressures remains conceptual. Some commentators theorise that a liquidity mismatch in one fund could lead to a run on redemptions in other funds. Yet this behaviour has not been observed, to any material extent, in recent market stress periods, such as March 2020. During this period, the "dash for cash" resulted in falling asset prices in fixed income markets. However, noting that price discovery is a function of markets, falling prices in the event of asset disposals is how markets function. As noted, falling prices alone do not in and of themselves constitute a systemic risk.

While noting the suspensions of funds during the initial phases of the March 2020 COVID crisis period, mainly UK Real Estate Funds and some Scandinavian bond funds, it is important to consider the causes behind the suspensions. These suspensions were due to valuation uncertainty – in the case of the Scandinavian funds, the suspensions were short-term and mainly because liquidity management tools, such as swing pricing, were unavailable. The effect of these suspensions was contained to those cohorts of funds – there is little evidence that these suspensions led to any material risks to other parts of the financial system, such as run risk on other funds. For the most part, investment funds could meet redemptions and adjust redemption values to reflect the prices that could be achieved on selling fixed income assets during this period.

In any case, as noted previously, when it comes to asset management activities, investors' assets are fully segregated from those of the asset manager. As such, the assets can always be sold to meet redemption requests, even if this cannot be achieved immediately. The risk from liquidity is that investors will have to wait for their redemptions, and that these will reflect the market value of the sale of the assets – a risk inherent in market-based products.

This is different from banking, where, due to leverage arising from lending and money creation activities, the bank can only ever pay a portion of creditors, such as depositors, at any time. A run on bank deposits can lead to a bank becoming insolvent and unable to pay depositors their money. This scenario has been observed in several bank collapses, most notably Silicon Valley Bank in 2023.

The IA welcomes and supports the adoption of a wider liquidity management toolkit in the recent amendments to the AIFM and UCITS directives. A broad toolkit is essential for managers to be able to manage microprudential risks. But the benefits of these tools are not limited to the management of microprudential risks. These tools are also invaluable in preventing the transmission of risks to the broader financial system. For example, swing pricing in an investment fund removes any first-mover advantage from buying assets when there is a larger deviation between mid-prices and spreads, removing an incentive to time redemptions in stressed markets. The ability to gate or suspend redemptions reduces the pressure for fire sales in the event of a liquidity crunch, reducing pressures on the overall market. Requirements for investment funds to maintain global exposure limits or to operate within disclosed maximum leverage limits prevent funds from building excessive leverage levels.

Of course, the asset management industry would welcome and support initiatives to improve liquidity in key markets, particularly fixed income and short-term funding markets. However, investment funds in many jurisdictions already have the tools to manage current levels of liquidity and prevent unmitigated liquidity mismatches. The amendments mentioned above to the AIFM and UCITS Directives will ensure that these tools are available in all EU jurisdictions.

Question 5. Where in the NBFI sectors do you see build-up of excessive leverage, and why? Which NBFIs could be most vulnerable? Please provide concrete examples.

The scope of our membership is the asset management sector. Our members manage segregated mandates for institutional investors, including pension schemes, insurers, charities, and local governments, and manufacture and manage asset management products such as investment funds for institutional and retail markets. Our greatest visibility is in these parts of the NBFI sector—we have limited coverage in other sectors.

Overall, we do not see a build-up of excessive leverage levels in the asset management sector. In the limited areas where more significant leverage is used (such as hedge funds and Liability-Driven Investment Funds), this is today carefully managed and subject to enhanced supervision. Following the post-GFC reforms, including the introduction of the AIFMD and the MiFID II directive, all areas of asset management in the EU, including alternative investment managers, are highly regulated and subject to supervision, including transparency reporting to regulators.

Managers of UCITS are subject to strict global exposure limits, limiting the incremental risk exposure they can gain to 100% of the value of the UCITS assets. They must have robust risk management processes and file these annually with their national competent authority. Alternative Investment Fund Managers (AIFMs, noting this is a broad term that captures managers of any non-UCITS fund) are also subject to strict risk management requirements, requiring them to have a robust risk management function independent of the portfolio manager, set and disclose maximum levels of leverage, and report levels of leverage to their NCAs. The AIFMD regulatory reporting framework includes additional reporting fields for AIFMs that employ significant leverage (defined as three times as measured by the commitment method).

A challenge for the asset management industry and macroprudential authorities is that leverage can be difficult to measure. Financial or balance sheet leverage, arising from borrowing to increase investment exposure, is relatively straightforward to measure. Synthetic leverage, arising from using derivatives, is more complex due to the widespread use of derivatives for reducing risk and managing portfolios efficiently. This activity does not generate additional incremental risk, and can even reduce risk. Simple measures of leverage, in particular the gross measure in AIFMD and the sum of notionals in UCITS, hugely overstate the actual risk exposure that arises from using derivatives.

These measures concerning synthetic leverage do not consider the directionality of the derivatives. They are only an indication of the level of use of derivatives in a fund/portfolio, not whether any additional risk exposure arises from these positions. For this reason, net notional exposure measures, such as the Commitment method used across both UCITS and AIFMD, are preferable. But even net notional exposure measures can have limitations. For example, three-month treasury futures usually have to be calculated to an equivalent exposure of a 10-year treasury, which significantly overstates the exposure level. For this reason, for funds that have significant derivatives usage, even where this is largely to hedge risk exposures, we consider that risk-based tools such as Value-At-Risk should be used as a complement to gross and net measures to gain a more accurate understanding of the actual risk exposure arising from the derivatives position, not just the size of the activity.

The IA cannot comment in detail on other sectors within NBFI. However, we note that some parts of the NBFI sector are subject to little or no regulation, and consequently there needs to be more transparency over their activities. Archegos was an example of an unregulated entity taking significant and poorly managed leverage risks. While often confused as a hedge fund, it was structured as a family office and, therefore, outside the regulatory perimeter. While it may be that the highly concentrated and leveraged risk exposures taken by Archegos were not representative of the activities of the typical family office in the US or Europe, it did highlight the need for more visibility of regulators over this sector within NBFI. Improving transparency in these areas should be a priority for macroprudential authorities.

The priority for macroprudential authorities should be to assess the existing data reported by different sectors within NBFI through various channels, invest in systems to cross analyse this existing data and identify gaps, focusing on those areas where little or no information is available. For the purposes of making cross-analysis of data reporting through different frameworks easier for authorities to analyse, the IA supports the mandatory reporting of key identifiers, in particular Legal Entity Identifiers (LEIs) and Unique Transaction Identifiers (UTIs), along with widely used identifiers such as ISINs where these are available.

Question 6. Do you observe any systemic risks and vulnerabilities emerging from crypto assets trading and intermediaries in the EU?

Certain crypto assets and related activities can transmit risks to the broader financial system. Still, the overall size of the crypto market seems unlikely to be large enough to present a risk to financial stability in the immediate future. Furthermore, it is important to distinguish between crypto and digitalised assets – digitalised assets are more established asset classes, such as fixed-income securities, investment funds, etc., that use digital tokens to represent the asset class and distributed ledger technology. At this stage, we see little reason to believe that the systemic risks in digitalised assets will differ materially from their more traditional forms.

Crypto assets, on the other hand, are based on digital stores of value, and therefore differ from digital tokens that represent traditional assets. Some crypto assets, such as Bitcoin, Ethereum and Ripple, are used as mediums of exchange. Money is used for three key purposes - a store of value, a medium of exchange and a unit of account. To perform these functions effectively, money must have the following characteristics – durability, divisibility, portability and inimitable (impossible to counterfeit). Some established crypto assets have tried to replicate these characteristics, although the high volatility of these assets makes these both a poor store of value and unit of account.

Currently, crypto assets are used very little as mediums of exchange in mainstream finance. Ethereum is increasingly used to exchange contracts, though we are unaware that the scale of use is significant enough to warrant macroprudential measures. The authorities should continue to monitor developments in crypto, but we are not aware that this presents substantial risks at present.

Question 7. Considering the role NBFIs have in providing greater access to finance for companies and in the context of the capital markets union project, how can macroprudential policies support NBFIs' ability to provide such funding opportunities to companies, in particular through capital markets? Please provide concrete examples.

We welcome the recognition that the NBFI sector has a vital role in providing companies with access to finance and the benefits to financial stability that diversifying funding sources away from the banking sector presents. This is not to diminish the role of funding from the banking sector, which will and should continue to play a vital role in financing the real economy. Indeed, some of the provision of finance will involve both the bank and NBFI sector.

Examples include securitisation, which enables NBFIs to purchase diversified loan securities, providing investment opportunities for NBFIs while releasing bank capital for further funding activities; and short-term MMFs, which provide short-term funding to banks through the purchase of financial commercial paper (CP) and certificates of deposits (CD) or overnight funding via reverse repurchase agreements.

We recognise that regulation can help realise the potential of these activities within the capital markets union. In particular, we welcome the EU Commission's consultation on targeted changes to the Securitisation Regulation to unlock greater use of responsible and robust securitisation in the market.

We are of the view, though, that the recent amendments to the AIFM and UCITS Directives have introduced measures in asset management designed to address financial stability risks, such as providing a standardised toolkit for liquidity management in investment funds, introducing regulatory reporting for UCITS and enhanced reporting for AIFs, and rules intended to limit perceived risks around loan origination funds.

Based on existing evidence, measures are more than sufficient to address identified risks. It is also notable that Article 25 of the AIFMD has already been successfully deployed in Ireland and Luxembourg to address emerging risks from significant leverage. For example, this measure was most successfully used to limit the leverage exposures of sterling Liability Investment Funds (LDI) following the September 2022 gilt market shock.

So far, no evidence presented by macroprudential authorities has pointed to financial stability risks that cannot be addressed through the existing tools available or the new tools recently introduced in the UCITS and AIFM Directives. Adopting macroprudential policies that are not sufficiently supported by evidence may damage the regulated parts of the NBFI sector, limiting their ability to provide financing for the real economy while having limited or negligible impact on the resilience of sectors such as asset management and investment funds.

We believe macroprudential authorities should focus their efforts on understanding and obtaining more information on the less regulated and unregulated parts of the NBFI sector. Addressing information gaps in these parts of the NBFI sector should identify whether there are unmitigated risks to financial stability that may arise from those sectors.

Chapter 3: Overview of Existing Macroprudential Tools and Supervisory Architecture in EU Legislation

3.1 Money Market Funds

Supervisory powers

Question 8. What are pros and cons of giving the competent authority the power to increase liquidity buffer requirements on an individual or collective basis in the event of system-wide financial stability risks? Under which other situation do you believe MMF liquidity buffers should be increased on an individual or collective basis by the competent authority? Please explain.

The IA does not support this measure. The ability of authorities to mandate increases by MMFs in their liquidity buffers would create uncertainty for MMFs and their investors. Such measures are likely to prove pro-cyclical, requiring MMF managers to sell (relatively) longer-dated securities in stressed markets to purchase overnight or weekly assets. The imposition of increased liquidity buffers will also create downward pressure on yields from daily and weekly assets, damaging the returns available to investors and creating incentives for those investors to withdraw. Such destabilising actions seem contrary to the intention of macroprudential policy.

The existing MMF regulation already provides significant liquidity buffers for MMFs. It should be noted that MMF managers hold liquidity over these and will vary depending on anticipated investor flows, over which they have more visibility due to the "Know Your Customer" (KYC) requirements in the MMF regulation and the evolving market conditions they observe. MMF managers are better placed to judge the expected levels of liquidity they will need and whether this needs to be increased. The successful management of liquidity levels in MMFs during the March 2020 Covid-related market crisis and the September 2022 UK gilt markets crisis, during which time no MMF breached its minimum liquidity requirements or failed to meet redemption requests from investors, demonstrates the ability of MMF managers to anticipate liquidity requirements.

In addition, for Low Volatility Net Asset Value (LVNAV) MMFs, the current link between threshold breaching and the potential activation of liquidity management tools has effectively made the existing minimum liquidity buffers unusable. The proposed removal of this link, referred to in the EU Commission's 2023 report on the MMF Regulation, will make existing buffers more usable in times of market stress. Removing the arbitrary 17.5% restriction on the inclusion of government and public short-term securities within the weekly liquid threshold would also be beneficial.

Given that European MMFs proved their resilience in the face of considerable outflows in the March 2020 COVID and the September 2022 UK gilt market stresses, beyond some enhancement such as delinking (as mentioned above), we do not consider that significant reforms are needed to the framework for MMFs. Instead, greater focus is needed on improving the functioning, efficiency, transparency and diversity of participation in Short Term Funding Markets (STFMs). Our responses to questions 30 to 38 cover these.

Question 9. How can ESMA and ESRB ensure coordination and the proper use of this power, and what could be their individual roles? Please provide specific examples or scenarios to support your view.

As noted in our response to Question 8, we do not support introducing this power and do not envisage a coordination role for ESMA and the ESRB in its use.

Reporting requirements

Question 10. Given the new UCITS supervisory reporting obligations and improvements to AIFMD reporting, how could reporting requirements under the MMFR be aligned, simplified and improved to identify stability risks (such as liquidity risks) and to ensure more efficient data sharing?

We believe the existing reporting requirements in the MMF Regulation provide regulators with a comprehensive data set. When the regulatory reporting regime for UCITS is introduced, MMFs that are UCITS should be exempted from it.

While aligning and simplifying the AIFMD, UCITS, and MMF Regimes may be desirable, these should not be grounds alone to reopen the existing MMF reporting requirements. Considerable investment has been made in systems and process development for the existing MMF reporting framework. Further changes to this framework will inevitably bring significant development costs to MMF managers, and the limited benefits of simplification and alignment are unlikely to outweigh these costs.

Stress testing framework

Question 11. Do you believe that the proposed enhancements to the stress testing framework listed above are sufficient to identify and mitigate liquidity risks effectively? If not, what specific elements would you suggest including in the strengthened supervision and remediation actions for detecting liquidity risks?

Given the comprehensive nature of the existing stress testing framework, it is not immediately apparent to our members that there is a need for amendments. Investor concentration is not automatically an enhanced risk factor – this depends on the nature and activities of the investor or investors that make up the MMF. In this respect, stress testing will be of limited value in predicting the risks that might arise. KYC is a far more valuable tool in understanding investor behaviour that might drive redemption pressures.

It should be noted that the existing MMF stress testing framework includes several tests of limited relevance to many MMFs. For example, these include stress testing on interest rate derivatives, which are not used by many MMFs. While open to additional stress testing requirements, these must reflect the activities and exposures undertaken by MMFs and are only required when relevant to a particular MMF.

Question 12. What are the costs and benefits of introducing an EU-wide stress test on MMFs? Should this stress test focus mainly on liquidity risks?

In principle, a market-wide analysis of stress events is the correct starting point. The challenge is undertaking this across multiple markets with multiple issues and potentially covering multiple currencies, which may make an EU-wide exercise too complex. Notably, the Bank of England's System Wide Exploratory Scenario (SWES) Exercise has proved a significant undertaking, lasting over a year, despite being focused on a key segment of a single jurisdiction. Stress tests at the national level based on key markets might be more feasible.

System-wide stress tests must be carefully planned and calibrated to ensure reliable and meaningful results. Given the diversity of MMFs across different EU jurisdictions, the assets they typically hold, and the investor bases they serve, designing such a stress test will be a considerable undertaking for authorities, and gathering the necessary information will be a significant exercise for both authorities and the industry.

We would expect any system-wide stress tests on MMFs to be focused on liquidity, given that MMFs do not present leverage risks by virtue of not having borrowing powers and only minimal use of derivatives for efficient portfolio management. Historically, we note that assumptions around MMF liquidity by macroprudential authorities have frequently proved incorrect.

An example was the analysis provided in the UK FCA's consultation paper CP23/28 to justify the significant increases in minimum liquidity thresholds. This assumed no secondary market liquidity was available in crucial short-term funding markets during recent stress events, such as March 2020 and September 2022. Our members were able to provide evidence of secondary market trading during the stress periods identified, contradicting the assumptions made. As noted, it is critical that policy relating to regulating MMFs and other investment funds, and by extension NBFIs more broadly, are based on evidence and not untested assumptions or theories.

Reverse distribution mechanism

Question 13. What are your views on the EU ban on a reverse distribution mechanism by MMFs?

We challenge the view that the existing MMF Regulation bans MMFs from using a reverse distribution mechanism (RDM). The interpretation provided by the Commission's Legal Services, which was eventually published after Freedom of Information requests, was, in our view, insufficiently robust and open to challenge.

While negative yield scenarios seem unlikely to arise in the medium term, the need for tools to address them cannot be ruled out in the future. Since the SEC has adopted the RDM for stable NAV MMFs, this mechanism should be available for EU MMFs. The use of the RDM by stable NAV MMFs must be exclusively reserved for resolving negative yields. This tool should not be used to reflect price changes in the underlying assets.

Should wider reforms to the MMF Regulation be proposed, we would support changes to explicitly allow MMFs to use the RDM in negative yield scenarios.

Question 14. Can you provide insights and data on how the reverse distribution mechanism has impacted in practice the stability and integrity of MMFs?

As sterling interest rates remained positive throughout the post-GFC period, RDM did not have to be deployed for sterling MMFs even before the introduction of the MMF Regulation and the so-called "ban" on RDM.

We are not aware of RDM having a negative impact on the stability and integrity of MMFs. On the contrary, the availability of RDM to address any negative yield scenarios in stable NAV MMFs is likely to reduce concerns about these issues, with investors knowing that negative yields in MMFs can be addressed without deviating from the stable NAV mechanisms that are valued by corporate, local government, and charity investors.

Liquidity and short-term instruments

Question 15. Should regulatory requirements for MMFs take into account whether the instrument they are investing in is admitted to trading on a trading venue (regulated markets, multilateral trading facilities or organised trading facilities) with some critical level of trading activity? Please explain your answer.

We support initiatives to improve the functioning and efficiency of short-term funding markets, and trading venues could play a role in achieving this aim. However, we do not regard admittance to a trading venue as a relevant consideration for the regulatory requirements of MMFs. This will introduce practical challenges for managers of MMFs, given that relatively low volumes of STFM instruments are currently traded on trading venues. The frequency of issuance of short-term assets makes the cost of using trading venues, rather than the over-the-counter (OTC) trading that is primarily used, expensive and often impractical. The transition of US Treasuries to central clearing has proved problematic in the US.

In our responses to section 3.3, we suggest improvements that might be made to improve STFMs. But MMFs have to be able to operate in STFMs as they are, and mandating or separating the requirements based on trading-on-trading venues via the MMF Regulation will be damaging.

3.2 Other Open-ended Funds (OEFs)

Link between liquidity mismatch and liquidity risks

Question 16. How can NCAs better monitor the liquidity profile of OEFs, including redemption frequency and LMTs, in order to detect unmitigated liquidity mismatches during the lifetime of OEFs?

A significant amount of data is already reported to NCAs by managers of OEFs, both EU-wide, such as Annex IV reporting under the AIFMD, and also at the national level, e.g., quarterly portfolio information to the CSSF in Luxembourg. At the time of authorisation, managers of authorised OEFs such as UCITS must disclose to NCAs the liquidity management tools they will be using to manage liquidity risks in their funds. Furthermore, most NCAs require to be notified of the activation of certain liquidity management tools, particularly fund suspensions.

It is our view that existing reporting, where properly utilised and shared across different authorities, should be sufficient to identify if there are any OEFs where further enquiries are necessary. The management companies of those OEFs where NCAs have potential concerns regarding liquidity mismatch risks can be contacted, and additional enquiries made regarding the liquidity risk management strategies and tools being deployed by the management company.

We recognise that the EU Commission and the EU bodies are interested in reviewing existing reporting frameworks with a view to making these more efficient, including removing unnecessary fields and streamlining overlapping reporting requirements. We welcome the intention behind this initiative, and certainly would welcome a more joined up approach to developing new reporting frameworks or amending existing reporting frameworks that need to be updated for another reason, eg where data gaps have been identified. That said, we would caution that much of the burden of reporting on firms is in developing the systems and processes needed for reporting frameworks. Once these are in place, much of this can be automated and becomes "business as usual". Therefore, we strongly believe that reporting frameworks should not be revisited solely for the purpose of improving their efficiency and removing overlaps – the significant costs in having to re-develop systems and processes to align to the new reporting frameworks are likely to outweigh any subsequent savings.

In our experience, duplication is most likely to arise where different authorities ask for what is essentially the same information, but in different formats. Such duplication can therefore be avoided by removing legal barriers to sharing this information, as noted above. If this cannot be achieved, then we suggest management companies should be able to submit the exact same reports given to one authority to other authorities requiring this information, to minimise the additional work on management companies, eg avoiding the need for reformatting, developing separate systems, etc. The Commission could also explore centralising the reporting of data into centralised repositories, where it could be accessed by all authorities, to save on duplication, though a full impact analysis including the costs and benefits of such an initiative, particularly in respect of existing reporting, would need to be conducted.

An example of where duplication can occur is in the ad hoc requests for data related to fund liquidity management, such as redemption flows, received by management companies from NCAs during periods of market stress, such as during March 2020. These asked for essentially similar information, but the information requests were not identical and the reporting formats, creating additional work for cross-border management companies (it was frequently the same teams dealing with the requests from multiple NCAs) and draining valuable resources which were already stretched due to dealing with the stressed market conditions. We suggest that this is an area where NCAs could consider a common template for ad hoc requests to submit the information that is most likely to be needed in times of market stress. (This might have more fields than is needed in all circumstances, but NCAs could direct management companies to complete only the fields it needs the information for in the current market conditions.)

Question 17. [To NCAs/EU bodies] What is the supervisory practice and your experience with monitoring and detecting unmitigated liquidity mismatches during the lifetime of OEFs?

N/A

Question 17. What is the data that you find most relevant when monitoring liquidity risks of OEFs?

Liquidity can be both subjective and highly changeable depending on different market conditions. Measuring this requires a combination of quantitative measures using assumptions based on trading experience in the market and qualitative judgements, such as different management companies taking different approaches. Our members typically report redemption volumes and days to trade being useful measures. In addition, as for MMFs, KYC is a valuable tool – understanding the nature of the investor base, levels of concentration and the likely cash flow demands of the investors is important when assessing what the liquidity demands are likely to be.

A current barrier to management companies getting the information they require is the lack of distributor feedback on underlying investors' nature, concentration and dealing patterns. Our members report that the information received from distributors for liquidity management purposes is frequently non-existent or insufficient. Given the critical role of KYC in effective liquidity management, the IA suggests that requirements on distributors and other intermediaries to provide information to management companies for liquidity risk management purposes be strengthened.

Some IA members continue to have challenges obtaining sufficient market data to assess liquidity risks, particularly in relation to fixed income markets. We are hopeful that ongoing regulatory initiatives in the EU and elsewhere will assist in addressing these gaps.

Question 18. [To NCAs/EU bodies] What supervisory actions do you take when unmitigated liquidity mismatches are detected during the lifetime of an OEF?

N/A

Question 19. On the basis of the reporting and stress testing information being collected by competent authorities throughout the life of a fund, how can supervisory powers of competent authorities be enhanced to deal with potential inconsistencies or insufficient calibration between the LMTs selected by the manager for a fund or a cohort of funds and their assets and liabilities liquidity profile? How can NCAs ensure that fund managers make adjustments to LMTs if they are unwilling to act? How could coordination be enhanced at the EU level?

The IA strongly believes that, generally speaking, management companies are better placed than supervisors to make decisions on liquidity management and when liquidity management tools should be deployed. Managers have the most detailed and up-to-date information, knowledge and experience of their funds. Decisions on whether to activate LMTs, are often time-sensitive, dependent on evolving market conditions, fund-specific flow data and redemption profiles, which can vary greatly from fund to fund. Importantly, this means managers will not take uniform action across cohorts of funds, and actions will differ between fund managers.

Where NCAs have concerns, this can be discussed with individual management companies, but it should not be assumed that a tool or the liquidity management process that is appropriate for one fund is necessarily appropriate for other funds. We do consider that managers should be able to justify to their NCA their rationale for the LMTs they have selected to be available for their products, and for the activation or non-activation of particular tools in particular market scenarios. We also emphasise that a close, pro-active and open engagement between supervisors and managers is critical in stressed market conditions.

We support sharing information across supervisors in different jurisdictions on liquidity scenarios, risk events, and tools that have been effective in their markets. It is valuable that such information is also shared with market participants across jurisdictions, to better inform their own decision making on the activation or otherwise of particular LMTs. However, given local market constraints, we caution against solutions being mandated by NCAs based on experience in other jurisdictions without discussions with local management companies on the feasibility and desirability of these practices.

In some cases, LMTs may not have been activated in some jurisdictions due to unavailability, legal uncertainty or an absence of clear guidelines from NCAs on how to calibrate or activate these. We anticipate this scenario being resolved when the RTS under the AIFMD and UCITS amendments directive are operationalised.

Finally, it is important that the deployment of LMTs is fully de-stigmatised, particularly around fund suspensions, so management companies are not disincentivised to activate LMTs where they are needed. These tools are in place to protect investors, and we encourage NCAs and EU bodies to continue emphasising this point in public. Clearly there have been examples where poor risk management or other control failures have resulted in circumstances where it has been necessary to activate LMTs such as suspension – in those cases, it is important to separate these in subsequent sanctions enforcement, and emphasise the sanctions relate to the prior failures rather the resultant activation of the LMT. This is critical to ensuring that where the activation of LMTs such as suspension arise due to circumstances outside of the management company's control, this action is not stigmatised and can be taken without management companies fearing reputational consequences for protecting their investors. A recent example of this was the suspension in March/April 2022 of funds with significant Russian holdings following the invasion of the Ukraine by Russia, and the subsequent imposition of sanctions and restrictions on transacting in Russian securities.

Question 20. [To asset managers] What measures do you find particularly effective to measure and monitor liquidity risk in stressed market conditions?

The measures mentioned in our response to question 17 also apply to monitoring liquidity risk in stressed market conditions. In addition, management companies find it useful to get views from dealers on trading desks, whether internal or external broker-dealers, on what they see in the market. In more recent years, prices of Fixed Income ETFs have also reflected falls in market sentiment during market crises, such as in March 2020, more quickly than on traditional market sources. Our members have often noted that prices quoted on market data feeds do not always reflect prices that can be obtained in the market in stressed conditions, particularly for bonds. Therefore, adjustments must be made to the valuations of assets based on the information received from market sources through fair value pricing processes.

It is worth noting that there are likely to be variations across market participants on their perceptions of liquidity, particularly in markets such as fixed income securities. Some management companies may have easier access to buyers of fixed-income securities such as pension funds. Therefore, as noted in our response to question 19, the fact that different views are being taken of liquidity in the same conditions should not be assumed that some management companies are incorrect or over-optimistic – this may reflect different feedback they are getting from trading desks based on the counterparties they have ready access to.

Question 21. [To asset managers] What difficulties have you encountered in measuring and monitoring liquidity risks and their evolution? Are there enough tools available under the EU regulations to address liquidity mismatches?

We refer to our responses to questions 17 and 20 regarding the difficulties encountered in measuring liquidity, particularly the lack of visibility through nominee companies to underlying investors and the limited transparency of fixed income markets. The liquidity management toolkit provided for in the amendments to the AIFM and UCITS Directives is sufficient to allow management companies to mitigate liquidity management risks. This is provided by the RTS and guidance developed by ESMA on liquidity management tools are appropriately calibrated and not overly prescriptive. For example, in the UK, deferred redemptions have been available as a liquidity management tool for UK-authorised funds (UK UCITS and Non-UCITS Retail Schemes) for the last two decades. Still, the management companies in the UK have struggled to utilise this tool due to how the detailed rules are drafted. Therefore, ESMA must avoid an overly prescriptive approach in its final guidance and RTS around the design and deployment of liquidity management tools, as noted in our responses to the ESMA consultations.

We support relevant disclosure of LMTs but caution that over-disclosure can damage their effectiveness in protecting investors and preventing impacts on wider markets. It is important that investors understand what LMTs the management company may deploy, and how they will operate if they are activated and the steps the management company will take to ensure investors are properly communicated with. We do not consider that disclosure requirements should extend in detail to setting out the market conditions in which LMTs will be deployed, activation thresholds for their deployment, or a priority order in which LMTs will be deployed. These latter measures would have the undesirable effect of constraining how the management company could act, eg if the circumstances determined that activation of LMTs occur at a different than expected threshold or in a different order of utilisation than had been disclosed and could also allow more experience investors to anticipate the activation and gain first mover advantages. Disclosure requirements therefore need to be carefully calibrated to balance the need for investors to be informed but avoiding constraints or over-transparency that could allow some investors to gain advantages over others.

Question 22. [To asset managers] What are the challenges in calibrating worst-case and stress-case scenarios related to redemptions and margin calls?

We consider that data availability is the main challenge. As noted in our response to question 17, IA members frequently encounter limitations on being able to get information via intermediaries, such as nominee companies, on underlying investors that is needed for liquidity management purposes. Better data would improve estimates of end-investor behaviour and redemption patterns. We recommend that measures are taken to strengthen obligations on distributors to cooperate with management companies on information required for liquidity management purposes. We emphasise that this information does not need to be too granular, eg management companies do not need to know the identities or personal details of investors. They do need sufficient information, such as to understand whether an underlying investor represents a significant proportion of a fund, or a group of investors have a common decision maker (eg they are part of a model portfolio service managed by a single adviser), and if so the circumstances they might sell, but we consider it should be possible for intermediaries to share this confidentially without having to disclose individual identities of distributors or even common decision makers, provided there is sufficiently close cooperation in the dissemination of critical information.

The limitations of market data also impact estimates of margin calls, where it can constrain managers' ability to assess market dynamics that drive margin calls. However, beside this, a major challenge market participants face in calibrating worst-case and stress-case scenarios related to redemptions and margin calls, is the limited information made available to them by intermediaries, especially CCPs. Market participants would benefit from greater transparency regarding the margin models used by their CCPs, as well as user-friendly margin simulation tools to stress test that information.

Stress testing is an important risk management tool, particularly identifying potential risks, points of weakness and where the likely points of failure are. It is important that sensible calibrations are made, allowing testing in reasonably foreseeable stress events. It is important that products have a suitable standard of resilience, but equally important that products can deliver the returns that investors expect. As with other asset management products and services, open-ended funds are "at risk" products – the purpose is to offer the potential returns available through investment risk exposure. It is important that the risk exposure, which gives the prospect of investment returns, is not diluted to accommodate extreme stress scenarios, noting that asset managers already have the tools to address the latter in the unlikely event they arise.

Stress testing should, therefore, aim to understand how open-ended funds are likely to behave in stress scenarios and of relevance to macroprudential policy, where risks may be transmitted to other parts of the financial system. It is reasonable to expect that open-ended funds should be structured to be robust in normal and moderately stressed market scenarios. However, severe stress scenarios should not be used to ensure that open-ended funds portfolios and redemption terms are structured to withstand the most extreme scenarios, where these will compromise the investment returns and ability for investors to redeem in normal conditions.

Of equal importance to stress testing is firms having robust risk management, governance and escalation processes to deal with crises efficiently where these occur. No amount of stress testing can absolutely predict what will happen in a crisis scenario. A strength of the existing asset management frameworks is their risk management and governance structures, strengthened by the requirement for these to be independent of the portfolio management function and, in many jurisdictions, by the requirement for management companies or fund boards to have independent directors. These structures include clear lines of escalation, so key decisions can be quickly escalated in stress conditions and decisions taken to protect investors in a fund as a collective and ensure all investors are treated fairly, where necessary deploying liquidity management tools. Although the deployment of liquidity management tools is primarily decided on investor protection grounds, it is our experience that these are aligned with financial stability considerations – preventing some investors from gaining a first mover advantage also reduces the likelihood of a run on a fund or cohort of funds. Some of our members have reported benefits from completing a dry run of implementing liquidity management tools, which has helped them identify and address any gaps or inefficiencies in their escalation, reporting and decision-making procedures.

Stress testing

Question 23. [To NCAs and EU bodies] When monitoring or using results of liquidity stress tests, are you able to timely collect underlying fund data used by managers and the methodology used for the simulation? Are there other aspects that you find very relevant when monitoring the stress tests run by managers?

N/A

Question 24. [To NCAs and EU bodies] How do you use information collected from stress tests at the fund level for other supervisory purposes and for monitoring systemic risks?

N/A

Question 25. [To NCAs and EU bodies] What are the main benefits and costs of introducing a stress test requirement at the asset management company level and how could this be organised?

N/A

3.3 Other NBFIs and markets

Other NBFIs

Question 26. What are your views on the preparedness of NBFIs operating in the EU in meeting margin calls, and on the ways to improve preparedness, taking into account existing or recently agreed EU measures aimed at addressing this issue? Please specify the NBFI sector(s) you refer to in your answer?

The IA responded in June to the FSB's consultation on Liquidity Preparedness for Margin and Collateral Calls, published in April 2024. Overall, we broadly supported the FSB's recommendations with the exception of principle 7, which, in our view, placed an excessive reliance on cash buffers, which are not appropriate tools for most investment products.

In our response, we noted that the majority of practices recommended by the FSB already reflect good practice in governance and risk management in the asset management industry. As well as considering redemption liabilities, asset managers increasingly take into consideration margin liabilities as part of their liquidity risk management programs. Asset managers increasingly consider, via KYC, what margin demands might impact their investors, noting that in March 2020 and September 2022, money market funds and fixed-income funds, in particular, experienced high outflows from investors needing to liquidate assets to meet margin calls. It is notable that managers of UK funds, and in most jurisdictions, were able to meet these demands. Therefore, the asset management industry is sufficiently prepared to meet margin calls.

That said, it is not helpful to only consider the preparedness of NBFIs. While the specific recommendations and measures applicable might vary between participants, it is important that a holistic consideration of how the whole market interacts is taken when considering macroprudential measures, including liquidity preparedness for margin calls. In particular, determining the appropriate liquidity needed and performing robust stress testing of liquidity preparedness for margin calls requires understanding how initial and variation margin calculations performed by counterparties and Central Clearing Counterparties (CCPs) will be calculated so that models can be appropriately calibrated. Margin transparency is a key element of this discussion.

We also reiterate that regulated NBFIs, which are already directly identified and actively monitored by securities, insurance, and pensions regulators, should be differentiated from non-regulated NBFIs, where their activities are less visible. Banks transacting as counterparties to non-regulated NBFIs may require enhanced counterparty risk monitoring and reporting.

Policymakers, including the EU Commission, should also consider measures that might reduce the reliance on cash in margining practices. The post-2008 reforms have undoubtedly reduced counterparty risk in derivatives transactions and amplified liquidity risks in stressed market conditions. The ability to use high-quality assets as collateral, such as government bonds for variation margin calls, and transfer these seamlessly without having to sell assets will reduce pro-cyclicality and the amplification of liquidity risks in the market without losing the benefits of counterparty risk mitigation.

Question 27. What are relevant risk metrics or tools that can be used to effectively monitor liquidity and margin preparedness across all NBFI entity types? Please provide examples specifying the sector you refer to.

With the exception of cash buffers, the FSB's framework for margin preparedness seems reasonable, and we recommend that the EU Commission align with it. This requires NBFIs to have sound risk management practices, understand margin exposures, and conduct suitable stress testing.

For asset management, we consider the existing regulatory reporting regimes, such as AIFMD Annex IV and EMIR, to provide sufficient information for NCAs and EU authorities, such as ESMA, ECB and ESRB, to monitor and identify any entities or funds that may be a concern. A more detailed examination of margin preparedness should focus on entities or funds with significant derivatives usage, such as LDI mandates and pooled funds (as mentioned below), or where there have been known failures in meeting margin payments. We are not convinced that beyond NCA's occasional monitoring of risk management practices in the firms and funds they supervise, more periodic reporting is needed beyond that already provided.

Pension Funds

Question 28. How can current reporting by pension funds be improved to improve the supervision of liquidity risks (e.g. stemming from exposure to LDI funds, other funds or derivatives), while minimising the reporting burden? What can be done to ensure effective look-

through capability and the ability to measure the impact of unexpected margin calls? Please provide examples also for other NBFI sectors.

When thinking about proportionality in supervising the liquidity risk exposures of pension funds, it is necessary to distinguish between liquidity needs for pension payments/member access/collective transfers (which are either generally predictable and regular or, in the case of collective transfers, done with significant lead-times) vs liquidity needs for margin and collateral calls to support the use of derivatives/repo for risk management purposes, including Liability-Driven Investment (LDI) strategies, where used. Margin and collateral calls are short-term, less predictable and may spike in periods of market stress, leading to further market dislocation. Accordingly, this is where the regulatory focus should be.

We note the ongoing consultation by EIOPA on its draft Opinion on the supervision of liquidity risk management of IORPs[4] and the suggestion contained within (paragraph 3.3) that to *"assess liquidity risk exposures of IORPs in relation to margin requirements on derivative positions, competent authorities should gather and analyse relevant derivative data of IORPs and establish monitoring tools, including stress tests and sensitivity analyses."*

Furthermore, we note that, in EIOPA's draft Opinion, medium and high levels of liquidity risk (as assessed by national regulators) amongst EU IORPs appear to be driven primarily by margin calls[5]. We, therefore, support a focus on monitoring IORP liquidity risk management for derivatives and repo purposes.

In that regard, we note that the CBI and CSSF already have in place a data template for monitoring the resilience of sterling-denominated LDI pooled funds. This could, in principle, be adapted for use by IORPs using derivatives and repo in several areas:

- Euro and USD-denominated LDI pooled funds
- IORPs using LDI strategies via a portfolio management service
- IORPs using derivatives for strategies other than LDI e.g. FX hedging

While the current template applies to LDI pooled fund managers, it could in theory be adapted for reporting by IORPs, thus building on an existing form of regulatory reporting.

We note that in the UK, The Pensions Regulator has, in guidance[6] for pension fund trustees, already set out a series of data points that may be useful for them in monitoring LDI resilience. Similar data points could be adapted more broadly for reporting by EU IORPs:

- The value of the assets available to meet cash calls
- The value and liquidity of assets earmarked for cash calls
- The size of the required liquidity buffers and how these compare to recent and long-term market volatility
- The size of market movement which needs to take place before the next collateral calls would need to be made, and how large these calls would be
- If any collateral calls have been made — which assets were sold, the price achieved for these assets, and how the processes performed — for example the time taken to meet the cash call
- Whether hedging has been lost or reduced during the reporting period, and the impact of this
- Reminders of the timelines for meeting cash calls to LDI arrangements
- Reminders of the dealing cycles of assets identified to meet cash calls

[4] Consultation Paper on the draft Opinion on the supervision of liquidity risk management of IORPs, EIOPA, 2024.
[5] See Figure 1, Annex II of the consultation document on the draft Opinion.
[6] Using leveraged liability-driven investment, TPR, 2023

Question 29. What would be the benefits and costs of a regular EU-wide liquidity stress test for pension funds and with what frequency? What should be the role of EU authorities in the preparation and execution of such liquidity stress tests?

In line with our response to Question 12 concerning the desirability of EU-wide liquidity stress tests for MMFs, we have similar views concerning such tests for pension funds. We note that EIOPA already has an existing stress test for occupational pension funds, although this is focused on overall resilience in terms of funding levels and risks to retirement benefits, rather than liquidity risk specifically.

As the UK's 2022 gilt market experience showed, it is possible for pension funds to both experience improved funding levels (due to rising interest rates reducing the present value of pension liabilities) whilst simultaneously experiencing a liquidity shock arising from margin and collateral calls. This experience suggests that a targeted focus on liquidity stress tests could be warranted.

If EIOPA were to expand liquidity stress tests to pension funds, the obvious way would be to incorporate it into the existing stress test. However, while we are not opposed to the idea, it would be an incredibly complex undertaking, reflecting the diversity in EU pensions markets and the extent to which IORPs in different jurisdictions use derivatives and repo differently and to a greater or lesser extent. Notably, the Bank of England's System Wide Exploratory Scenario (SWES) exercise has proved a significant undertaking, lasting over a year, despite being focused on a key market in a single jurisdiction. Stress tests at the national level might be more feasible.

Any EU-wide stress test for pension funds would need to be very carefully planned and calibrated to ensure the results were reliable and meaningful. Given the diversity of pension funds across different EU jurisdictions, the investment strategies they typically follow, and the investor bases they serve, the design of such a stress test will be a considerable undertaking for authorities and gathering the necessary information a significant exercise for both authorities and industry. Any proposal to introduce EU-wide stress tests for pension funds should, therefore, be undertaken cautiously.

Short-term funding markets

Question 30. What would be the benefits and costs of creating a framework or a label in EU legislation for certain money market instruments (such as commercial papers) to increase transparency and standardisation? Should the scope of eligible instruments to such framework/label be aligned with Article 3 of Directive 2007/16/EC60? If not, please suggest what criteria would you consider for identification of eligible instruments.

The IA supports voluntary initiatives such as STEP to standardise the issuance of money market instruments, but notes that the take up of these initiatives to date has been limited. Given the challenges of labelling regimes in recent years, such as STS in the EU or SDR in the UK, we are not convinced that the EU should pursue a legislative label in this area. Instead, we would prefer the EU Commission and other authorities to encourage the take-up of the existing STEP label and continue to pursue voluntary codes of practice to increase transparency and improve market efficiency. The UK's Money Market Code, published by the Bank of England, is another example of industry codes that can be helpful.

Question 31. Would the presence of a wider range of issuers (notably smaller issuers) to fund themselves on this market, and therefore diversify their funding sources, be beneficial or detrimental to financial stability?

From the perspective of the IA's members, a more comprehensive range of smaller issuers is unlikely to reduce financial stability risks. Our members' MMFs typically invest in commercial paper with top credit ratings or those assessed internally as having the strongest credit quality. This is necessary to protect capital, which is an integral objective of an MMF. Diversification of funding sources for commercial enterprises may reduce reliance on bank funding, which in turn may reduce risks for the financial system and the real economy.

Question 32. What are your views on why euro-denominated commercial papers are in large part issued in the 'EUR-CP' commercial paper market outside the EU? What risks do you identify? Please provide quantitative and qualitative evidence, if possible.

Our members report that euro-denominated commercial paper issuance outside the EU is popular as an alternative source of short-term funding for banks in third countries, such as those in Australia, allowing them to source funding from non-domestic issuers. This, in part, reflects the perception of the euro as a global currency, which was one of the goals of the European Monetary Union (EMU). EUR-CP issued by high-quality banks in other jurisdictions is also valuable in diversifying risk for euro-denominated MMFs. However, in practice such paper tends to be traded only in those markets in the country it is issued.

We do not consider that this activity poses any material systemic risks for EU markets.

Question 33. What could be done to improve the liquidity of secondary markets in commercial papers and certificates of deposits?

Improving the transparency and efficiency of these markets, particularly pricing and potential buyers, and attracting more and diverse participants would help improve the liquidity of these markets. Initiatives such as STEP, the standard codes of practice, adoption of technology solutions such as electronic trading platforms are all likely to be helpful, but it is unlikely that a single solution will increase secondary market liquidity. While banks traditionally provided a market-making role in short-term funding markets, banking reforms introduced since the GFC have, while making banks more robust, increased the capital requirements on banks and reduced the balance sheet capacity for banks to hold money market instruments.

While we consider that overall, the post-GFC reforms have improved the robustness of banks, we would welcome reconsideration of some aspects of their capital requirements to see if they can be recalibrated to allow for greater balance sheet capacity to participate in short-term funding markets without compromising their resilience.

It should be noted, however, that the assumption that commercial paper and certificates of deposit cannot be traded on secondary markets is not true. Secondary market activity in these assets is low, but that is mainly because these are short-dated assets that are typically purchased in primary markets by managers of MMFs or other asset managers requiring some liquid assets in line with their anticipated cash flow demands, and then held to maturity. However, low activity does not necessarily translate into low liquidity. As mentioned in our response to Question 12, our members were able to provide evidence of secondary market trading during the stress periods in March 2020 and September 2022.

Question 34. Considering market practice today, is the maturity threshold for 'money market instruments' (up to 397 days) in the Eligible Asset Directive 2007/16 sufficiently calibrated for these short-term funding markets?

This maturity threshold of up to 397 days is longstanding, having been adopted for over 50 years, is widely understood and accepted by the markets and we consider is sufficiently calibrated for short term funding markets. We do not consider there is any reason to replace this.

Question 35. Do you think there is a risk with the high concentration of this market in a few investors (MMF and banks)? Please elaborate.

The opaque nature of European STFMs makes it difficult to assess concentration levels in this market, though estimates put MMFs as comprising less than half of the overall STFM investors[7]. MMFs are among the most heavily regulated and therefore visible participants, hence why they are often considered as analogous to the investor base for this market.

IA members report that trading volumes and dealing capacity in secondary STFMs is limited. This has been exacerbated by a decline in market making activity by banks in STFMs, which is widely attributed to a reduction in their balance sheet capacity following post-GFC reforms.

It is clear that STFMs could benefit from improvements to their transparency, accessibility and participation to enable a more efficient market to operate. As noted in other parts of our response, there is no single "silver bullet" solution that will fix these. A range of solutions, such as some standardisation, improvement in information feeds, technology platforms and a recalibration of banking capital requirements could all assist on improving the functioning of STFMs, as noted in our response to question 33.

Question 36. How could secondary markets in these money market instruments attract liquidity and a more diverse investor base, while relying less on banks buying back papers they have helped to place?

We consider that the improvements to short term funding markets identified in our response to question 33 would attract a more diverse investor base. The incentivisation of banks to return to acting as market makers in short term funding markets might give more reassurances to other groups of investors and increase their participation in these markets.

Question 37. What are the benefits and costs of introducing an obligation to trade on trading venues (regulated markets, multilateral trading facilities and organised trading facilities) for such instruments?

The IA does not have a fixed view on how short-term funding markets should be structured and can see the potential benefits of increased adoption of electronic trading. However, for some issuances of short-term instruments, the costs of listing the instrument on a trading venue can be significant relative to the size and duration of the instrument. While we are open to exploring initiatives to remove barriers to trading assets through trading venues, the Commission should not introduce an obligation on MMFs or other financial companies to trade on these venues. Complying with a trading obligation would negatively impact managers of MMFs, both through increasing operations costs and limit trading opportunities, particularly if these venues are not used by unregulated participants such as corporates. We see no evidence that constraining some participants to trading only via trading venues will increase the level of secondary market activity in short-term assets, which is characterised by its wholesale nature driven primarily by OTC trades. Participants purchasing money market instruments, typically expect to hold these to maturity, limiting secondary activity – this will be the case whether secondary trades happen OTC or via a traded venue. Individual brokers often know potential buyers they can approach when a secondary transaction is required.

Question 38. Can the possibility to trade on a regulated venue increase the chances of secondary market activities in a systemic event, for instance by acting as a safety valve for funds that need to trade these assets before maturity (especially when facing strong redemption pressures, like for MMFs)?

[7] Viewpoint lessons from Covid19: Experience of European MMFs in Short Term Markets, BlackRock, July 2020

We consider that increased options to trade, in particular improving the transparency and efficiency of short-term funding markets, may make secondary market liquidity more ready to come by in the event it is required, but we emphasise as in our response to Q37 that we do not consider that an obligation to trade money market instruments on a trading venue should be imposed.

Commodities markets

Question 39. How would you assess the level of preparedness of commodity derivatives market participants in terms of meeting short-term liquidity needs or requests for collateral to meet margins? Please rank from 1 to 5 (lowest to highest) the level of preparedness for the following participants by sector: insurance companies, UCITS funds, AIFs, commercial undertakings, investment firms, pension funds.

IA members do not typically undertake significant activity in commodities markets. Furthermore, UCITS are not permitted to invest in commodities or commodities derivatives unless it is a derivative that is referenced to a diversified index based on commodities (ie not a single commodity). The IA's insights in this area are therefore limited.

We do not consider it is appropriate to offer a view on how other NBFI sectors listed in question 39 should be ranked, as we do not have sufficient visibility on the preparedness of each sector, nor does the list provided by the Commission include all NBFI sectors, including some that might be higher risk. We also caution the Commission against considering responses by organisations representing a particular sector that seek to rank other sectors as lower preparedness than their sector out of self-interest.

As noted in question 26, we consider that asset managers overall have a high level of preparedness for margin calls in respect for the products and services they provide, including the management of mandates for pension schemes and other clients, and the management of UCITS and AIFs.

Question 40. In light of the potential risk of contagion from spot markets or off-exchange energy trading to futures markets, do you think that spot market participants should also meet a more comprehensive set of trading rules for market participation and risk management? Please elaborate on your response.

The IA does not cover these markets, and therefore we do not have a view on this question.

Question 41. How can it be ensured that the functioning of underlying spot energy markets and off-exchange energy trading activity does not lead to the transmission of risks to financial markets?

The IA does not cover these markets, and therefore we do not have a view on this question.

Other markets

Question 42. To what extent do you see emerging liquidity risks or market functioning issues that can affect liquidity in other markets? Can you provide concrete examples?

As noted, dealer capacity in fixed income and short-term funding markets have for some time been constrained, due to the impact of post-GFC banking reforms. The success of these reforms has largely been judged on the basis of the resilience of the banking sector. This is an entirely relevant consideration, and on this measure we agree that the resilience of the banking sector has been improved, notwithstanding that risks in this sector remain as highlighted by the collapse of Silicon Valley Bank and Signature Bank, and the emergency sale of Credit Suisse in March 2023.

We are of the view that in reviewing the effectiveness of the post-GFC reforms, consideration should also have been given to the impact of these on various functions performed by banks, including their role in intermediating fixed income and short-term funding markets. The significant withdrawal of banking activity in this area in our viewpoints to a need for a more holistic review of the post-GFC reforms, to assess whether they can be recalibrated to allow for more intermediation activity while maintaining the benefits of enhanced resilience.

The IA has long been concerned about the falls in initial public offerings on regulated exchanges globally, a problem that is particularly relevant for European exchanges. Regulated exchanges offer investors the most efficient, transparent, and liquid way for them to trade and invest in securities. The fall in the number of companies choosing to list publicly is resulting in asset managers and their investors increasingly turning to private markets. We view increased participation and democratisation in private markets as a positive, given the potential for long term performance arising from illiquidity premiums, and the ability to channel more capital into emerging enterprises. But private markets come with much less liquidity, transparency and higher barriers to participation. Price discovery in private markets is far more challenging.

The decline of public markets is leading to more concentrated markets, with investors increasingly relying on a small number of dominant firms for the investment returns needed to achieve their investment goals, eg retirement. The costs and regulatory hurdles in running listed companies have clearly deterred many private companies from choosing to list and have incentivised many public companies to de-list. The frameworks for regulated markets need to be revisited to remove barriers to companies choosing to list, and remaining listed, once they reach a more mature stage of their formation cycle.

We also note the influence that decisions made by benchmark providers can have on markets. The prospect of a company entering into a key benchmark, or being removed from a benchmark, will impact on trading in those companies as asset managers and other investors with mandates linked to those benchmarks adjust their holdings to reflect benchmark changes. The Benchmark Regulation has increased governance standards on regulated benchmarks, but the cost of benchmark licencing has increased materially over recent years, with IA members reporting these costs more than doubling. Benchmarks are used by asset managers for a number of functions, including risk monitoring as well as performance monitoring. The importance of transparent and accessible market information to well-functioning markets cannot be overlooked. If licencing costs become too prohibitive, this will increasingly influence choices of benchmarks, which could result in less regulated NBFIs participating in capital markets selecting less appropriate benchmarks or basing market decisions on poorer data.

Chapter 4: Excessive Leverage

4.1 Open-ended funds (OEFs)

Question 43. What are other tools than those currently available under EU legislation which could be used to contain systemic risks generated by potential pockets of excessive leverage in OEFs?

As noted in our response to question 5, some leverage measures used in investment funds, including open-ended funds, can significantly overstate the economic exposures that investment funds are taking, particularly where derivatives are used for activities such as hedging. From this perspective, it is important that the measures used to consider leverage reflect incremental economic risk exposure taken by investment funds, which overall is low, and not just the use of derivatives by investment funds.

It is our view that the existing tools available in the EU to manage leverage risks in open-ended funds are demonstrably sufficient. The UCITS Directive limits both borrowing to temporary uses only and the global exposure that UCITS can take to the value of the scheme property. This imposes a de facto limit on the incremental exposure that UCITS can take. UCITS are also required to ensure that leverage exposures are covered.

The AIFMD includes additional reporting requirements for AIFs employing significant levels of leverage, defined as over three times leveraged using the Commitment Approach. The Annex IV reporting includes additional risk metrics, such as VAR, which were not required in the AIFMD but NCAs can elect to require that AIFMs in their jurisdiction provide – our understanding is that the majority of NCAs require this additional information to be provided when it is available. This gives NCAs, along with ESMA and other EU bodies such as the ESRB a significant pool of information on the use of leverage.

Article 25, which allows NCAs to set limits on the risk exposure that AIFMs can take on an AIF or a group of AIFs, was operationalised through the issuance by ESMA of Guidelines for NCAs in December 2020. The powers in Article 25 have been used by the CBI to impose leverage limits and restrictions on redemptions on Irish real estate funds, and by the CBI and CSSF to impose yield buffers on LDI funds (see question 44).

The amendments to the AIFMD enacted this year include new requirements on loan originating funds, applying leverage limits both to closed-ended and open-ended loan originating funds, which will apply from 14 April 2026. The leverage limits on loan origination funds that are OEFs are much stricter, at 175% compared to 300% for closed-ended funds.

Overall, we consider the existing provisions in the EU legislative framework already either restrict leverage or provide sufficient tools for NCAs to manage leverage risks. Any further restrictions or tools could unduly limit the ability of OEFs to manage risks in portfolios or gain delta market exposure more efficiently through the use of derivatives, limiting access to investors of strategies that may be optimal for their investment requirements.

Question 44. What are, in your view, the benefits and costs of using yield buffers[8] for Liability-Driven funds, such as it was done in Ireland and Luxembourg, to address leverage?

In the highly specific case of UK Defined Benefit (DB) pension funds following LDI strategies, we supported the use of yield buffers. LDI strategies rely significantly on derivatives and repo to help pension schemes hedge their liabilities, resulting in the creation of leverage, the liquidity risks of which must be managed. The maintenance of yield buffers is a standard way in the LDI industry of managing this leverage. This was true before the UK's 2022 gilt market crisis; what changed following the crisis was the fact that these yield buffers became a *regulatory requirement* and were set at a higher level than previously (300-400bps vs 100bps on average before the crisis).

We note that the yield buffers introduced in Ireland and Luxembourg were limited to sterling denominated LDI funds. This reflects a key feature of the UK's 2022 gilt market volatility, which was the concentration of the long-dated and index-linked portion of the gilt market in the hands of Defined Benefit (DB) pension funds that were following a similar investment strategy, in line with their national regulatory framework. The CBI and CSSF noted[9] this concentration – and the absence of an equivalent pension fund ownership concentration in the EU and US government bond markets – as a key reason for limiting the use of yield buffers to GBP-denominated LDI funds.

While, all else equal, higher yield buffers can reduce the risk of high leverage, they increase the cash drag on investor portfolios. For long-term investors such as pension funds, which do not normally hold high levels of cash, high yield buffers can impose a significant cost in terms of cash drag.

Outside of the LDI sector we do not support the use of yield buffers. The long-only investment strategies that investment managers implement on behalf of clients do not normally create leverage to the extent seen in the LDI sector. Yield buffers therefore serve no purpose in such a setting.

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[8] "The yield buffer is defined as the level of increase in yields that a fund can withstand before its net asset value (NAV) turns negative." See, The Central Bank's macroprudential policy framework for Irish-authorised GBPdenominated LDI funds, p. 3.

[9] Feedback Statement to CP157: Macroprudential measures for GBP liability driven investment funds, CBI, 2024

Question 45. While on average EU OEFs are not highly leveraged, are there, to your knowledge, pockets of excessive leverage in the OEF sector that are not sufficiently addressed? Please elaborate with concrete examples.

Investment funds in the EU are highly regulated, particularly UCITS and Retail AIFs, which restrict the use of leverage. Managers of professional AIFs are also highly regulated, giving NCAs transparency on their leverage activities. Strategies such as hedge funds that deploy significant levels of leverage tend to be domiciled in jurisdictions outside the EU, have limited redemption opportunities and are only available to professional investors who understand the risks.

We are therefore not aware of any EU OEFs that are highly leveraged that are not sufficiently addressed, and in any case the existing tools will enable NCAs across the EU to identify and mitigate any leverage risks as they arise.

Question 46. How can leverage through certain investment strategies (e.g. when funds invest in other funds based in third countries) be better detected?

Exposures of fund of funds (FoFs) to underlying alternative funds employ that employ significant levels of leverage will undoubtedly present investment risks to the FOFs and their investors. However, we do not see that these present risks to the wider financial system, especially in the EU. Investment fund structures are typically ring-fenced, meaning that investors do not have liabilities beyond their initial subscriptions or committed capital. FOFs such as UCITS and Retail AIFs are generally not permitted to invest in third country AIFs that are heavily leveraged. Investment in FOF AIFs that invest in such funds is therefore limited to professional investors who understand and can absorb the risks to their investment capital.

We do not see a risk transmission mechanism that goes beyond the loss of invested/committed capital of those FOFs that invest in these funds. There is of course the possibility that losses could be incurred by banks based in the EU providing the leverage (through lending or derivatives contracts) to the underlying funds, which could have systemic implications, but this should be managed through the credit risk management policies of banks rather than via requirements on NBFIs.

4.2 Other NBFIs and markets

Question 47. Are you aware of any NBFI sector entities with particularly high leverage in the EU that could raise systemic risk concerns?

The IA represents asset managers, asset owners and managers of investment funds, including ETFs and MMFs. We do not have visibility over all sectors of NBFI. We would observe that while asset managers and managers of investment funds, along with some other NBFIs such as insurers and pension funds, are highly regulated industries where NCAs and EU bodies have good visibility of leverage and other risks, some parts of NBFI are less regulated and the risks are less visible. This became apparent with Archegos. Rather than considering additional regulatory and transparency for sectors that are already well regulated, we suggest that EU authorities should focus on increasing transparency over less or unregulated NBFIs where there are not the same risk management requirements as for regulated NBFIs and hidden leverage risks are more likely to be present.

Question 48. Do stakeholders have views on macroprudential tools to deal with leverage of NBFIs that are not currently included in EU legislation?

As noted in our response to question 43, we are of the view that NCAs and EU bodies already have sufficient tools to address any risks arising from the use of leverage in asset management activities.

The introduction of any macroprudential tools to deal with leverage risks should be supported by evidence. Noting that there are less or unregulated parts of NBFI where there is less visibility of activities and the risks posed, we suggest that NCAs and EU bodies initially look to address these information gaps through appropriate reporting mechanisms ahead of determining whether any further legislative tools are required.

Question 49. [To NCAs and EU bodies:] Are you able to timely identify (financial and synthetic) leverage pockets of other NBFIs (such as pension funds, insurance companies and so on), especially when they are taken via third parties or complex derivative transactions? Please elaborate on how this timely detection of leverage could be obtained?

N/A

Question 50. How can it be ensured that competent authorities can effectively reconcile positions in leveraged products (such as derivatives) taken via various legal entities (e.g. other funds or funds of funds) to the ultimate beneficiary?

It is our view that via existing reporting such as EMIR, AIFMD Annex IV, and reporting to the ECB, competent authorities already have access to a significant body of information. Better utilisation of this information could enable central banks, securities regulators and supranational authorities in identifying risks across legal entities and sectors. This could be achieved through:

- Better sharing of data between authorities
- The mandatory use of identifiers such as LEIs and UTIs in all regulatory reporting frameworks all jurisdictions
- Better use of "big data" analytical tools (we note these have already been adopted by many authorities)

We understand that there are legislative constraints on NCAs, EU bodies and global organisations sharing information. We suggest that those legislative constraints are addressed to ensure better utilisation of existing data without additional burdens on the industry.

Commodities markets

Question 51. What role do concentrated intraday positions have in triggering high volatility and heightening risks of liquidity dry-ups? Please justify your response and suggest how the regulatory framework and the functioning of these markets could be further improved?

The IA has no comment on this question.

Chapter 5: Monitoring Interconnectedness

Question 52. Do you have concrete examples of links between banks and NBFIs, or between different NBFI sectors that could pose a risk to the financial system?

We do not have examples of interconnectedness in respect of asset management, and we do not regard the assertion of the interconnectedness between NBFIs such as asset managers and investment funds and banks or other NBFIs to have been demonstrated.

In the context of macroprudential risks, interconnectedness points to the transmission risks arising in one part of the financial system so that they threaten the viability of other parts of the financial system. This goes beyond the mere existence of interactions.

Interconnectedness has been observed in the banking sector, most recently relating to the collapse of Silicon Valley Bank (SVB) in the US in March 2023. The collapse of SVB led to the collapse of Signature Bank, and a loss in confidence at other regional banks requiring the intervention of the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). There are no examples of failures in the asset management industry or investment funds leading to failures in other funds or other parts of the financial system that we are aware of. For example, the suspension and subsequent termination of the Woodford Equity Income Fund in the UK in 2019 did not lead to suspensions or collapses in other investment funds. Other examples of asset management failures that did not lead to wider issues include the collapse and sale of New Star in 2009, and Barings Asset Management as part of Barings Bank in 1995.

The fact that these failures did not lead to more widespread problems for the financial system is not due to luck, but structural features of asset management and investment funds. Unlike banks, in asset management, assets are segregated from both the balance sheet of the asset manager and the assets of other investors. Similarly, the assets held by investment funds are segregated from those of the asset manager, to the extent that they are entrusted to a depositary for safe keeping. This ring-fencing feature of asset management greatly limits the potential to transmit risks to other parts of the financial system.

There is some evidence of pockets of risk arising from asset management activities influencing the financial system, but these tend to arise due to concentration of similar investment groups in particular markets rather than interconnectedness. An example of this is the dominance of UK Defined Benefit Pension Schemes pursuing Liability Driven Investment Strategies in long dated gilt markets, which has been mitigated through yield buffers, particularly for pooled LDI funds. (See our responses to questions 28 and 29). The problems encountered in the September 2022 UK gilt markets crisis did not arise due to interconnectedness between LDI investors or their counterparties – there is no evidence the failure of one LDI strategy, or LDI pooled fund, would have led to the collapse of other LDI strategies or pooled funds. Rather, this was a one-way market where participants had to react the same way to an unexpected yield spike following the then UK government's announcements around fiscal policy.

We do not think it prudent to introduce macroprudential policies for NBFIs intended to address interconnectedness without the existence of such risks being unequivocally demonstrated through evidence. Reliance should not be placed on academic theories that have yet to be observed in practice.

Question 53. What are the benefits and costs of a regular EU system-wide stress test across NBFI and banking sectors? Are current reporting and data sharing arrangements sufficient to perform this task? Would it be possible to combine available NBFI data with banking data? If so, how?

The IA has followed the System Wide Exploratory Scenario (SWES) exercise undertaken in the UK by the Bank of England with interest. Participants include firms in banking and NBFIs, including insurance, pension funds, asset managers, investment funds and hedge funds. The IA is supportive in principle of the SWES, though it has not had sight of the methodologies or scenarios used in the exercise, including how these have been calibrated, which could affect the analysis and the outcomes. We are therefore reserving an opinion on the exercise until the final report is issued.

It is notable that this has been a costly and time-consuming exercise both for the Bank of England and participants in the SWES, taking around 18 months to complete in what is a relatively limited and straightforward market consisting of a single issuer (the UK government) in a single currency (pound sterling). We do not rule out the possibility of a similar EU-wide exercise being conducted, but even if this were to be restricted to the eurozone, the complexity of designing such a process across 20 different countries, with separate government issuers of varying credit quality, and markets with different institutions and practices, should not be underestimated. Should this be extended to all EU member states, this would introduce further complexity of inclusion of the 8 currencies present in the EU.

The experience of the Bank of England's SWES exercise is that it is unlikely that EU bodies would be able to rely on existing data. The first part of the SWES involved an initial data gathering exercise, even before the original scenario was constructed. The Bank then had to use further data in order to determine how aggregate responses might collectively impact the scenario, before providing an amended scenario in the second phase. The number and diversity of participants across an EU system-wide would be considerably greater, adding to the scale and complexity of the data gathering required, let alone the aggregation of responses to the stress scenario.

Should EU bodies wish to pursue system-wide stress testing, a less ambitious program focusing on particular jurisdictions or particular markets, eg the issuance from one Member State, might be more achievable. The outcomes would be of interest to the industry as well as national and EU authorities, but the exercise would have to be very carefully constructed and calibrated to be meaningful. The IA considers these should be information gathering exercises to better understand the links between different parts of the financial system. Stress testing has limitations – these can never perfectly simulate a crisis, how participants will behave and the stresses that participants will experience. There are inevitably a series of simplifications and assumptions that are embedded in any scenario stress testing models, which will affect the accuracy of the findings, and this will be even more so for system wide stress tests, given the complexity of these involving a range of participants. Overconfidence in the outcomes of such stress tests could result in counterproductive regulatory actions being developed. We do not consider these should be used to set a macroprudential policy framework for NBFIs or for determining prescriptive rules for NBFIs, such as liquidity ratios or prudential requirements.

Question 54. Is there a need for arrangements between NBFI supervisors and bank supervisors to ensure timely and comprehensive sharing of data for the conduct of an EU-wide financial system stress tests? Please elaborate.

Please see our response to question 53.

Question 55. What governance principles already laid out in existing system-wide exercises in the EU, such as the one-off Fit-for-55 climate risk scenario analysis or the CCP stress tests conducted by ESMA, could be adopted in such system-wide stress test scenario?

It is our view that an EU system-wide stress test of key financial markets would be considerably more complex than those undertaken in the above scenarios – please refer to our response to question 53.

We do not consider that the Fit-for-55 climate scenario analysis or the CCP stress tests conducted by ESMA to be relevant for a system-wide stress scenario. The Bank of England's System Wide Exploratory Scenario (SWES) exercise could provide a more indicative model, but consideration of the SWES as a possible model will need to await the publication of the final report, expected before the end of this year.

We consider that there are certain minimum considerations that should apply to the design of any system wide stress test scenario:

- System wide stress tests must have a clear and pre-defined purpose to study how all significant market participants influence a specific market in a specific scenario. As noted in our response to question 52, the purpose should be to gather information not to set policy requirements.
- Supervisors conducting the tests must not make assumptions about market participant behaviour. Market participants should be consulted, so that observations on the behaviour of market participants in response to a scenario are based on their experience, not desk-based simulations devised by supervisors.
- Each individual participant's behaviours and available options will be influenced by the decisions and reactions of other participants, in particular their counterparties, as well as regulation and directions from supervisors.

- Any such system wide stress test should be proportionate and time-limited, taking into consideration the significant data and resource demands on participants in the exercise.

IA members who participated in the Bank of England's SWES exercise have broadly found this to be an interesting exercise and have welcomed the engagement with the Bank. Nonetheless, they report that the operational burden has been immense. On this basis, we do not consider that system-wide exercises should be held frequently – an annual or even a bi-annual exercise is in our review unrealistic, and would impose a huge cost and resource burden on both market participants and the supervisory bodies conducting these tests. We suggest that, should the Commission and other EU bodies consider a system wide stress test, this is conducted initially as a one-off exercise.

Question 56. [To NBFIs and banks] In your risk management practices, do you run stress tests at group level, and do you monitor the level of interconnectedness with (other) NBFIs (within and beyond your own sector; e.g. portfolio overlaps)?

IA members do not generally consider that it is meaningful to run stress tests at group level, eg across funds and/or mandates managed by different entities within the group. Even funds and mandates that are in the same broad categories can experience market events in very different ways. This will be influenced by the client base for each fund or mandate. Some funds may be more likely to experience redemption pressures in times of market stress, eg they may have investors who have exposures to potential margin calls, or be part of a model portfolio service controlled by a single distributor making quarterly reallocations. Other funds, while ostensibly similar, may have very different investor bases. There may be exceptional cases where there is an argument to perform a stress test across a group of funds which share the same investment process, or where there are concerns over concentration or market liquidity, particularly if in aggregate the manager has relatively large positions in particular assets, but unless these factors are present, overall we do not consider that group level stress testing is likely to be meaningful.

It is our understanding is that monitoring and stress testing that considers other NBFI entities will be very difficult to achieve in practice – even at group level there are considerations on Chinese Walls and client confidentiality which make market stress testing across groups challenging. There is even less visibility on activities and portfolios of other market participants. Asset managers will generally not have sufficient information across other NBFIs to take their activities into consideration in stress testing.

We do not consider there to be any value in implementing stress testing on the management company entity itself. As has been demonstrated (noting the examples of Barings Asset Management and New Star Asset Management provided earlier in our response), the failure of an asset manager has limited implications for the wider financial system, due to the agency model of asset management and the segregation of assets. Unlike other sectors, the balance sheet risks that would justify such stress testing do not exist in asset management models to any significant extent, and in this respect, size is of little relevance given the activities are not reflected in the balance sheet of the asset manager.

Chapter 6 Supervisory Coordination and Consistency at EU Level

6.1 Open-ended Funds (OEFs)

Question 57. How can we ensure a more coordinated and effective macroprudential supervision of NBFIs and markets? How could the role of EU bodies (including ESAs, ESRB, ESAs Joint Committee) be enhanced, if at all? Please explain.

To ensure a more coordinated and effective macroprudential supervision of NBFIs and markets, it is crucial to enhance coordination and data sharing between regulators. The IA supports these efforts but does not have a specific view on the best approach to achieve this. Regulators should aim to standardize and ensure consistent formats are used to gather information, including ad hoc requests, from managers of Open-

Ended Funds (OEFs). This standardization will facilitate more efficient data collection and analysis, leading to better-informed regulatory decisions.

Furthermore, EU authorities should consider enhancing communication, coordination, and data sharing mechanisms on an international level, including with non-EU competent authorities. Given that market crises are often global in nature, such international cooperation is essential to effectively monitor and mitigate systemic risks. By fostering a collaborative approach, EU bodies such as the European Supervisory Authorities (ESAs), the European Systemic Risk Board (ESRB), and the ESAs Joint Committee can play a pivotal role in strengthening the resilience of the financial system.

Enhanced coordination mechanism (implementation and adoption of NMMs[10])

Question 58. How could the currently available coordination mechanisms for the implementation of macroprudential measures for OEFs by NCAs or ESAs (such as leverage restrictions or powers to suspend redemption on financial stability grounds) be improved?

As noted in our response to questions 57, the IA favours improved coordination between NCAs and EU bodies. The IA is agnostic on how this may be achieved – what matters more is that a common regulatory framework is applied, rather than which body specifically oversees this. The IA agrees that current coordination frameworks can be utilised for this purpose, noting the coordination between ESMA, the CBI and the CSSF in respect of the implementation of yield buffers for LDI funds. (See our responses to questions 28 and 29 for more on this). It is also notable this example of effective coordination also involved UK authorities, in particular the Bank of England and the FCA, highlighting the importance of coordination with regulators from outside the EU where there are common challenges to be addressed.

Undoubtedly, an improved ability of NCAs and EU bodies to share information, as highlighted in our response to question 50, would improve the effectiveness of coordination at EU and international levels. Restrictions on the ability to share information often led to NBFIs having to report essentially the same data to multiple bodies in different formats, which is unnecessarily costly and time consuming. If these data sharing challenges cannot easily be overcome, we suggest that NCAs and EU bodies accept a copy of the data reported under the primary reporting framework, so NBFIs do not at least have to provide the information in different formats, according to different methodologies, etc.

Finally, we emphasise that in the case of investment funds, management companies are best placed to decide whether a liquidity management tool or a leverage limit should be implemented. Directions by NCAs or EU bodies to impose these should only be given in extreme circumstances, eg where a management company has failed to react to extreme stresses and provided insufficient justification to NCAs for not applying a tool to the extent that lack of intervention by the management company represents a significant risk to investors and/or the broader financial system. We think such instances are very unlikely to occur, given the regulation, strong governance and risk management requirements that apply to managers of OEFs. Coordination between NCAs and EU bodies can play a valuable role in feeding information back to managers of OEFs particularly during stressed periods, assisting them in making appropriate decisions for their circumstances.

Question 59. What are the benefits and costs of introducing an Enhanced Coordination Mechanism (ECM), as described above, for macroprudential measures adopted by NCAs?

The IA can see a rationale for the use of an Enhanced Coordination Mechanism (ECM), noting these have been used in other frameworks, although we would want specifics of how the mechanism would be applied in the case of coordination for measures relating to OEFs before giving an opinion.

[10] NMMs – National Macroprudential Measures

Solutions for NBFIs must be tailored for NBFIs – macroprudential measures should not simply be copied from measures that apply to banks, noting significant differences between banking and NBFIs, particularly asset management, highlighted elsewhere in this response.

Question 60. How can ESMA and the ESRB ensure that appropriate National Macroprudential Measures (NMMs) are also adopted in other relevant EU countries for the same (or similar) fund, if needed?

We do not have detailed views on the coordination mechanisms that should apply in the EU, and how NMMs or other coordinated action would be extended to EU countries outside of the ECM in the event the latter is adopted. We emphasise the points made in our response to question 58 – we view the importance of a consistent and coordinated application of the regulatory framework more important than who is leading the actual supervision and emphasise that in nearly all cases the decision on whether to implement tools should be made by management companies rather than NCAs or EU bodies.

Question 61. Are there other ways of seeking coordination on macroprudential measures and possibly of reciprocation? What could this system look like? Please provide concrete examples/scenarios and explain if it could apply to all NBFI sectors or only for a specific one.

We do not have any additional recommendations in addition to the responses given in questions 58-60.

Supervisory powers of EU bodies

Question 62. What are the benefits and costs of improving supervisory coordination over large (to be defined) asset management companies to address systemic risk and coordination issues among national supervisors? What could be ESMA's role in ensuring coordination and guidance, including with daily supervision at fund level?

We are unsure why enhanced supervisory coordination is deemed necessary over "large" asset managers. There is to our knowledge little, if any, evidence that the activities of large asset managers on their own pose more of a risk than smaller managers given our central role as a transmission mechanism for client allocation preferences not a discretionary allocator. As noted previously in our response, the segregation of assets is a key structural difference between the asset management industry and other parts of the financial system, particularly banking and insurance, where customers are exposed to balance sheet risks of those entities. The regulatory frameworks that apply to NBFIs are also a relevant consideration. It is notable that Archegos was not a particularly large entity, nor was it regulated.

Where risks of a systemic nature have arisen, such as in the LDI episode of September 2022, these are largely attributable to concentrations of investors pursuing similar strategies in specific markets. This effect arises from the collective effect of multiple actors, rather than being attributable to any one entity, though more examination is needed to reach definitive conclusions.

Ultimately it is for the EU member states to determine the best way to organise the division of regulatory powers and coordination between EU bodies and NCAs, and we encourage the Commission to take into consideration views expressed by national and European trade associations from EU member states. But we caution against any approach being decided based on assumptions or observations based on other financial sectors, especially banking, which ignore key differences in structural features and the regulatory frameworks of asset managers.

Question 63. What powers would be necessary for EU bodies to properly supervise large asset management companies in terms of flexibility and ability to react fast? Please provide concrete examples and justifications.

Please refer to our response to question 62.

Question 64. What are the benefits and costs of having targeted coordinated direct intervention powers to manage a crisis of large asset management companies? What could such intervention powers look like (e.g. similar to those in Article 24 of EMIR)?

Please refer to our response to questions 3, 52 and 62 – we do not see a strong argument in favour of intervention powers specifically aimed at large asset management companies, noting past examples of asset management failures have not had broader market effects.

6.2 Other NBFIs and markets

Question 65. What are the pros and cons of extending the use of the Enhanced Coordination mechanism (ECM) described under section 6.1[11] to other NBFI sectors?

The considerations given in our response to question 58 also apply to other NBFI sectors, such as insurance and pension funds, though noting the diversity of sectors that fall within NBFI, the specifics of individual sectors would need to be considered in the application of the ECM to those sectors.

ESAs and ESRB's powers during emergency situations

Question 66. What are the benefits and costs of gradually giving ESAs greater intervention powers to be triggered by systemic events, such as the possibility to introduce EU-wide trade halts or direct power to collect data from regulated entities? Please justify your answer and provide examples of powers that could be given to the ESAs during a systemic crisis.

As noted in our response to question 60, we do not consider it appropriate to express a view on how regulatory powers in the EU should be divided between NCAs and EU bodies such as the ESAs, and in this respect would encourage the Commission to take into consideration the views expressed by national and European trade associations from EU member states. We do consider that a coherent and consistent application of EU frameworks across the EU is important, but this can be delivered by NCAs working in coordination with the ESAs and other NCAs.

It is important that decisions on interventions reflect the circumstances in local markets, and the more removed a body is from the local market, the more difficult it is to have the necessary visibility to make appropriate interventions. For this reason, we consider that most decisions, including in emergency situations, should be made by the governing bodies of management companies who have the greatest visibility over relevant information on their products, their investors, their portfolios, the trading environment they are experiencing, etc. NCAs will also be closer to their local markets and the NBFIs they regulate.

[11] Section 6.1 on Open-ended funds (OEFs), page 27

Integrated supervision for commodities markets

Question 67. What are the benefits and costs of a more integrated system of supervision for commodities markets where the financial markets supervisor bears responsibility for both the financial and physical infrastructure of the commodity futures exchange, including the system of rules and contractual terms of the exchange that regulate both futures and (cash/physical) forward contracts?

We do not have a view on this question.

International coordination

Question 68. Are there elements of the FSB programme on NBFI that should be prioritised in the EU? Please provide examples.

In respect of asset management, we are of the view that the recent amendments to the AIFM and UCITS Directives have already addressed much of the FSB programme on NBFIs, and we note the Commission already intends to consult on changes to the MMF Regulation in its next term. We await the FSB's consultation report on Leverage in NBFIs, expected in December, and the Commission may need to take into consideration any recommendations on leverage measures that are made in this report, although we will not offer a definitive opinion until this is published.

Overall, we consider that the EU Commission should prioritise exploration over less or unregulated NBFIs, in particular the gaps in data and visibility of NCAs and EU bodies over those areas. It is these areas that are less understood where hidden risks are more likely to be present, rather than heavily regulated sectors such as asset management.