

SFC Response to the European Commission's NBFi consultation

Key vulnerabilities and Systemic risk

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?

We see a benefit in identifying more clearly what NBFIs are as definitions vary and tend to encompass a variety of heterogeneous actors with varying risk profiles. In order to identify potential and relevant risk profiles we propose applying a two-step approach, which can then help identify potential sector specific issues.

Proposed two-steps approach

The first step consists of assessing whether a specific NBFi is competing with banks in similar activities. Indicators of this include where a NBFi engages in maturity/ liquidity transformation, leverage or credit risk transfer. The second step consists of evaluating if there is the potential of the NBFi contributing towards systemic risk.

As an example, we illustrate this two-step approach by reference to the fund:

1) Assess similarities of activities with bank activities

Activities to be assessed: Maturity/liquidity transformation, leverage, credit risk transfer.

Categories:

- Fixed Income Funds: May engage in maturity/liquidity transformation.
- Money Market Funds (MMFs): Limited maturity/liquidity transformation.
- Private Credit Funds: May involve maturity/liquidity transformation if open-ended, unlikely if closed-ended.
- Real Estate Funds: May engage in maturity/liquidity transformation.

2) Assess and evaluate systemic risk contribution

However, both traditional and alternative funds are highly regulated, minimizing systemic risks.

- Fixed Income Funds: Use liquidity management tools (LMTs) effectively. Typically no leverage is employed.
- MMFs: Robust structures relying on maturing securities for redemptions. No leverage is employed. It should be noted that MMFs performed well during COVID-19.
- Private Credit Funds: Again, if open-ended, private credit funds rely on using LMTs to manage liquidity effectively. It should be noted that minimal leverage is typically

employed. In terms of credit risk transfer it is important to note that this is not a feature of this sector and that the fund managers own incentives remain aligned with the performance of the loans in which the private credit fund invests.

- **Real Estate Funds:** Open-ended real estate funds manage liquidity by using LMTs. Closed-ended funds more closely align the potential for redemptions with the liquidity, and intended sale timelines, of the of the real property asset in which the fund is invested. In each case, they generally operate with minimal leverage.

Conclusion: The systemic risk contribution of the funds sector is minimal, as both traditional and alternative funds are already highly regulated and subject to bespoke sector-specific regulation. There are already a number of micro- and macro-prudential provisions in the investment fund sector that guard against investment funds contributing to the build-up of systemic risks. These include liquidity risk management rules, fund-level stress testing and leverage limits.

In addition, the investment fund sector is inherently diverse. Many funds have investment strategies where the redemption terms are, in general, aligned with liquidity of the underlying assets which mitigates the likelihood of them contributing to the build-up of systemic risks. Though certain cohorts of open-ended funds invest in less liquid assets (e.g., real estate funds and some corporate debt funds), it does not necessarily mean that these funds exhibit a liquidity mismatch provided that appropriate use of LMTs is made.

For the regulated NBFIs sector, such as the fund sector, the focus should not be on further regulating these entities and activities but rather on improving the resilience of the broader financial system. This can be achieved through targeted recommendations and proposals, which are detailed throughout our response to the consultation. However, some of our key recommendations are highlighted below for better understanding.

Recommendations

- **Liquidity Preparedness:** Increase the liquidity preparedness of market participants, in particular by increasing the transparency and predictability of margin calls. Being able to use highly liquid assets (such as MMFs), alongside cash, as collateral for margin calls would limit the contagion during stressed market conditions and contribute to financial stability.
- **Use Existing Micro-and Macro-prudential Tools:** Investment funds can rely on LMTs to manage redemptions (especially unexpected ones) and do not need to ensure a perfect match between the liquidity of their assets and the potential for redemptions. The uniform, wide spread and rigorous use of LMTs, as adopted under the AIFM/UCITS Directives' review, will contribute to macroeconomic stability.
- **Stress Testing:** Enhanced supervisory stress testing frameworks may help inform the selection and use of specific LMTs by management companies.

- Make Better Use of Existing Supervisory Data: Much of the information that regulators need to analyse macroeconomic risk already exists. In the EU, even richer data will exist after the introduction of the enhanced reporting regime under the AIFMD review. However, ESMA could support greater sharing of supervisory data between national authorities.
- International Supervisory Collaboration: Further harmonization for the purpose of macroeconomic systemic risk assessments would be helpful. At the same time, it should be considered how data can be shared with firms. For example, data that is relevant for banks' counterparty risk assessments.

Unregulated Sectors

It is also important to assess the systemic risks that may arise from other, less regulated or unregulated sectors within the NBFIs landscape (e.g., big techs, crypto asset markets, sovereign wealth funds). However, it is not necessarily the case that an entire sector can be said to be contributing to systemic risk. Instead, there may be certain activities being carried on within a sector, or across several sectors, that may potentially contribute to systemic risk. Accordingly, regulators need to approach the identification process from an activity-based perspective rather than a whole sector-based perspective. Recognizing that macroeconomic risk assessments should not be confined to the EU alone, we would also support broad international cooperation, specifically the sharing of supervisory data and insights between EU and closely connected financial markets.

Big tech

Big tech companies, though currently deriving modest revenue from financial services, have the potential to become “too big to fail” entities within the financial market. Their swift growth in areas such as payments and credit is outpacing traditional banks; for instance, in China during 2020-2022, big tech credit grew by 37% compared to 13% for bank credit. This accelerated expansion introduces several systemic risks to the financial sector.

Unlike the EU's well-established regulatory framework in the funds sector, current regulations for big tech remain underdeveloped. They often target individual entities or specific activities rather than addressing the cumulative risks that arise from these companies' integrated operations. In addition, regulatory inconsistencies across jurisdictions and between big tech and traditional financial institutions exacerbate these challenges and could threaten financial stability. Existing frameworks do not adequately address the combined risks associated with big tech's mixed financial and non-financial functions.

To manage these risks, a comprehensive public policy approach is needed. We advocate for adapting regulatory frameworks to better capture the unique challenges posed by big tech and for enhancing cross-border regulatory cooperation.

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.

Additional measures to address these exposures are not necessary for banks. If regulators have concerns about the performance of NBFIs, they should focus on NBFIs that remain outside of regulatory oversight. Credit institutions effectively manage risks arising from their exposures to NBFIs through a variety of measures. In global markets, the primary risk for banks is credit counterparty risk (CCR), with Credit Valuation Adjustment (CVA) relevant as well, albeit to a lesser extent. Credit risk is also a consideration for exposures within the banking book. Current prudential measures account for potential losses from transaction closures and liquidations due to missed margin calls, as well as refinancing risks in risk-off scenarios. For example, the proposed BSBC Counterparty Credit Risk Guidelines emphasize concentration and illiquidity risks when assessing regulatory exposure at default (EAD).

Question 3 To what extent could the failure of an NBFIs affect the provision of critical functions to the real economy or the financial system that cannot easily be replaced?

1 - To a very low extent

2 - To a low extent

3 - To a significant extent

4 - To a high extent

5 - To a very high extent

Don't know / no opinion / not applicable

[Please select one option]

Please explain in particular to which NBFIs 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.

In regard to MMFs, we believe that the extent to which their failure could affect the provision of critical functions to the real economy or the financial system is low. The 2023 European Commission report showed that due to the protections of the MMF Regulation MMFs fared well during the liquidity stress experienced during the COVID-19 related market turmoil of March 2020, the interest rate increases, and related financial asset re-pricing. No EU-based MMF had to introduce redemption fees or gates or to suspend redemptions during these stress events.

To further increase MMFs' resilience, we are in favor of delinking the activation of LMTs from the liquidity buffer requirements for MMFs, as has been proposed in other jurisdictions, so that the existing buffers can be used when appropriate.

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

The current EU UCITS and AIFM Directives already provide NCAs with tools to monitor and manage the liquidity and leverage profile of funds. By contrast, NCAs have no power to monitor the liquidity profile of non-regulated NBFIs. Given that the investment fund sector is already highly regulated, it is also appropriate to assess the systemic risks that may arise from other less and non-regulated NBFIs sectors such as crypto-asset service providers (CASPS) and big tech. We also support ongoing international work to increase the liquidity preparedness among market participants as well as transparency and predictability of margin calls. Being able to put highly liquid assets (such as MMFs), alongside cash, as collateral for margin calls would limit the contagion during stress market conditions and contribute to financial stability.

The CP contains several references to family offices (as unregulated entities or in relation to Archegos), in our view, there is very little evidence that family offices as a category present enhanced risk and / or contribute to systemic risk. In our experience, family offices tend to be conservatively run and, typically, use the services of regulated investment management firms. The Archegos incident appears to be a 'one-off' example of an improperly (indeed, fraudulently) run family office that was conducting hedge fund like trading strategies while operating under a very limited regulatory framework. This would not have been possible in the EU nor would they have been able to amass significant positions without being reported.

The issue that led to losses in the banking sector was caused by a) a lack of transparency as to the derivatives positions being built up (but the SEC has now proposed rules on reporting large equity-based swap positions which will address this); and b) the pledging of the same type of collateral with multiple prime brokers resulting in downwards market movement when such collateral needed to be sold (which could have been addressed by a wider range of collateral being pledged). Regulatory interventions targeting family offices would need to clearly identify risk in the EU and any regulatory gaps, rather than be based on the behavior of a single firm operating outside of the EU under a different regulatory framework.

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

The vast majority of funds do not employ significant leverage. Moreover, leverage is often deployed for reasons other than gaining additional exposure to an underlying market, including for efficient portfolio and risk management purposes. It cannot, however, be excluded that some leveraged investment funds may face steep liquidity demands during periods of stress. For this reason, supervisors should focus on these funds that are at

greater risks of a liquidity shortfall due to sudden margin calls. NCAs already have the possibility to introduce leverage limits under the UCITS and AIFM Directives or maintain yield buffers for individual or group of funds to ensure the stability of leveraged positions. The revised AIFMD Directive introduces an absolute leverage limit for loan originating funds. Therefore, EU regulated funds such as UCITS and AIFs cannot build up excessive leverage, contrary to non-regulated NBFIs.

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

The integration of crypto assets within the financial ecosystem has introduced new opportunities and risks. Whilst the ESRB has not yet categorized crypto assets as a source of systemic risk, their novelty, growing scale and uneven transparency gives rise to possible vulnerabilities that have the potential to destabilize the wider financial system.

We also note the recently finalized Markets in Crypto Assets Regulation (MiCA) introduced by the EU to regulate the cryptocurrency and digital assets market and address these risks. However systemic implications could arise for NBFIs in the EU from crypto asset service providers based outside the EU.

Crypto markets are characterized by extreme price volatility, and NBFIs engaging in crypto-related activities are exposed to rapid shifts in asset values. In the event of a market downturn, forced liquidations could affect not only the NBFIs themselves but also their investors, creditors, and counterparties, creating a potential contagion effect within the broader financial system. Given the illiquid nature of many crypto assets, NBFIs may also face challenges in quickly unwinding positions during times of market stress. This could lead to liquidity shortages, especially for the non-regulated NBFIs sector.

However, the challenges stemming from extreme price volatility and liquidity shortages are not concerning for the regulated EU fund sector, as there are already frameworks with existing rules in place to mitigate these risks. Nonetheless, regulators should address these vulnerabilities within the non-regulated NBFIs that have significant crypto exposure to ensure overall financial stability.

Traditional banks engaging in crypto-backed lending benefit from stricter regulatory oversight, financial buffers, and risk mitigation strategies to address the high volatility associated with cryptocurrencies. They also possess more robust processes for monitoring counterparties. In contrast, NBFIs engaging in those activities generally lack comparable oversight and safeguards. Consequently, in the event of a major crypto market decline, leveraged NBFIs could be forced to meet margin calls or face substantial losses, which may have implications for their counterparties across both the NBFIs and traditional financial sectors.

Further, lending activities secured by crypto collateral introduce counterparty risk, particularly if the underlying crypto assets experience significant devaluation. This can lead to a cycle of collateral liquidation that depresses prices further and heightens financial strain on non-regulated NBFIs. Some NBFIs operate as intermediaries in crypto markets - offering custody, trading, and lending services. However, these institutions often lack the same level of regulatory oversight as traditional banks, leaving them more vulnerable to operational risks, including cybersecurity breaches and system outages. Cybersecurity risks are especially pronounced in crypto markets, as exchanges, wallets, and custodial platforms are frequent targets for cyber-attacks.

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.

Measures could be taken to improve the functioning of the short-term funding markets. This includes electronic trading platforms to enhance transparency and market depth; less fragmentation and more harmonization of the EU commercial paper and certificates of deposit market; and considering recalibrating bank capital requirements to make it more efficient to make larger markets in commercial paper.

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.

Increasing liquidity buffers in response to a system-wide crisis lacks justification and would undermine the stability and efficiency of the financial system.

We oppose granting National Competent Authorities (NCAs) the power to dynamically adjust liquidity buffers for Money Market Funds (MMFs). This level of intervention is unwarranted, as demonstrated in the 2023 European Commission report, which found that the MMF Regulation performed effectively during liquidity stress events. These included the market disruptions of March 2020 due to COVID-19, subsequent interest rate hikes, and financial asset repricing. Importantly, no EU-based MMF had to implement redemption fees, gates, or suspend redemptions during these periods of stress.

Beyond the lack of justification, implementing dynamic liquidity buffers could harm the financial system. Adjusting MMF liquidity thresholds in response to liquidity stress

might worsen, rather than relieve, market instability by triggering procyclical effects that could intensify the downturn.

Furthermore, we see no need to increase liquidity buffers, particularly for Variable Net Asset Value (VNAV) funds. Although the UK and US have recently increased such buffers, we believe that a 50% weekly liquid asset requirement, as a share of total assets under management, is excessive. A preferable approach would be to decouple the activation of Liquidity Management Tools (LMTs) from MMF liquidity buffer requirements, as in certain other jurisdictions, allowing existing buffers to be utilized when needed.

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.

Based on our answer to the previous question, we do not see the need for ESMA and/or the ESRB to be granted the proposed power. Indeed, we do not even consider it viable to be able to increase liquidity buffers during a market stress event.

While addressing the need for better coordination, we see a key area for improvement in data sharing between ESMA and the NCAs. As the supervision of MMFs is today primarily conducted at the local level rather than at European level (e.g. reporting on stress testing), prioritizing the improvement of data sharing between local regulators and ESMA is key but also between ESMA and the ESRB.

NCAs should remain responsible for the adoption of macroprudential measures given the specificities of each EU Member State's fund markets. ESMA should liaise with NCAs and help coordinate their actions. For example, ESMA should make NCAs aware of macroprudential measures being taken by other NCAs and help them decide if they should adopt similar measures.

More broadly, macro-prudential supervisors should also work with their micro-prudential counterparts, who have more intimate knowledge of investment funds identified as potentially contributing to the build-up of systemic risks.

As macroeconomic risk assessments cannot be considered on an EU basis alone, we would also support sharing of supervisory data and insights between EU and closely connected financial markets.

Reporting requirements

Question 10: In view of 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?

Achieving alignment is difficult due to the level of detail and specificity in the MMFR reporting requirements. If further alignment is sought, efforts should focus on minimizing redundancies and streamlining the reporting process.

For example, when comparing the MMFR requirements (Article 37) with those of the amended UCITS Directive (Article 20a), it is clear that the MMFR requirements are far more detailed and tailored to Money Market Funds (MMFs). This is also the case with the Article 37(4) reporting template, which includes additional data such as stress test results.

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?

We see merit in exploring system-wide stress testing to identify and understand vulnerabilities stemming from links between different NBFIs, and between banks and NBFIs, including in relation to the risk of amplification and herding behaviours embedded in large portfolio overlaps. However, it is important to take into account the limits of being able to model the whole financial system. The FSB and IOSCO's planned work on system-wide stress testing may also facilitate cross border cooperation between authorities and understanding interconnectedness between players across borders. Therefore, the EU may want to defer its decision to establish a system wide stress testing before this exercise is complete.

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?

The common stress testing framework for MMFs is already extensive. MMFs undertake annual stress tests with parameters set by ESMA and MMF managers, including the profile of their fund investors and whether they are margin sensitive. Therefore, potential enhancements to the common stress testing framework would be limited in impact.

Instead, the EU should also explore the extent to which there are data gaps from non- or less-regulated NBFIs sectors that can be a source of systemic risk, such as sovereign wealth funds, big techs and CASPS, and consider policy intervention if this is determined to be a relevant gap. Such data gaps could be informed and identified by system-wide stress testing.

Reverse distribution mechanism

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

The RDM offers MMFs a more effective way to manage the impact of negative interest rates while preserving stable net asset values (NAVs), thereby enhancing transparency for investors and strengthening the financial system's resilience.

In low or negative interest rate environments, RDM helps MMFs maintain a stable NAV by gradually reducing the number of shares outstanding, rather than lowering the NAV itself. This is more attractive to investors, such as corporate treasurers, and is more compatible with existing accounting systems. By allowing RDM, fund pricing volatility would be reduced, and it would align more closely with investor expectations for stability and low-risk investments.

The EU's ban on RDM creates a disparity between two of the world's largest financial markets as the U.S. has recently reintroduced it.

Allowing this mechanism in the EU could help prevent regulatory arbitrage, where investors move their funds to regions with more flexible MMF structures. It would also align the EU with international practices, contributing to a more cohesive and predictable financial environment. European MMFs, widely used for corporate cash management and short-term investing due to their stability, could further safeguard investor confidence by providing a mechanism to maintain stable NAVs, even in challenging economic conditions.

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

The use of RDM has no effect on the stability of MMFs. Instead it allowed MMFs to maintain a stable price of 1 unit of currency per share, which is helpful operationally. This practice has provided utility for 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.

MMFs invest in short-term funding instruments. Short-term funding instruments are typically traded over-the-counter (OTC). It would be disproportionately expensive to require such short-lived instruments to be listed.

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? [To NCAs/EU bodies] What is the supervisory practice and

your experience with monitoring and detecting unmitigated liquidity mismatches during the lifetime of OEFs?

Though certain cohorts of open-ended funds invest in less liquid assets (e.g., real estate funds and some corporate debt funds), it does not necessarily mean that these funds exhibit a liquidity mismatch.

The current EU UCITS and AIFM Directives already provide NCA with tools to monitor and manage the liquidity profile of funds. By contrast, NCAs have no power to monitor the liquidity profile of non-regulated NBFIs. The liquidity profile of OEFs varies significantly and depends on an individual fund's portfolio, investor base, the use of leverage, underlying assets, frequency of subscriptions and redemptions and market conditions.

Management companies should have the possibility of choosing between several LMTs currently available, depending on the specificities of the funds under their management. Existing LMTs, alongside the refinements of AIFMD II, are sufficient to manage fund liquidity appropriately. If universally adopted by funds, these LMTs contribute to macroeconomic stability. It is important to leave management companies sufficient flexibility on deciding when to activate such LMTs, as envisaged in the AIFMD Review, as this will avoid a mechanistic application of these tools and resulting 'cliff effects'. However, enhanced supervisory stress testing frameworks may help inform the selection and use of specific LMTs by management companies.

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

Monitoring liquidity risks of OEFs requires a comprehensive approach guided by various data points:

- Redemption Coverage Ratio: Measures how quickly assets can be converted to cash to meet redemptions, though it must be viewed in the context of each fund's stress scenarios.
- Knowing the investor base, especially large or volatile investors who can create significant redemption challenges.
- Macro data such as interest rates and financial indices provide broader market context and micro data on inflows, outflows, and asset values
- Results from regular stress tests
- Internal reviews by liquidity risk committees, which can be increased in times of market stress
- Clear risk management procedures communicated to regulators

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

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?

Management companies should have the possibility of choosing between several LMTs currently available, depending on the specificities of the funds under their management. Existing LMTs, alongside the refinements of AIFMD II, are sufficient to manage fund liquidity appropriately. If universally adopted by funds, these LMTs contribute to macroeconomic stability. It is important to leave management companies sufficient flexibility on deciding when to activate such LMTs, as envisaged in the AIFMD Review, as this will avoid a mechanistic application of these tools and resulting 'cliff effects'. However, enhanced supervisory stress testing frameworks may help inform the selection and use of specific LMTs by management companies.

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

The UCITS Directive and the AIFMD impose strict liquidity management and reporting requirements. Specifically, asset managers must develop and implement liquidity risk management plans (LRMPs) that detail how liquidity risk is monitored, managed, and addressed during periods of stress.

Stress testing plays a critical role in EU liquidity risk management. Under both AIFMD and ESMA guidance, asset managers are required to conduct regular stress tests to simulate extreme market events. These tests focus on assessing the ability of a portfolio to meet redemption requests and liquidity needs during extreme market dislocation, with scenarios that reflect potential liquidity crises.

Another key measure is the Liquidity Coverage Ratio (LCR), which was introduced under the Basel III framework and is applied to EU-regulated financial institutions. While traditionally used by banks, asset managers apply this ratio to their portfolios to ensure they hold sufficient high-quality liquid assets (HQLA) to cover potential outflows during stressed conditions. The LCR is especially important for monitoring the capacity to meet short-term obligations within a 30-day period.

In addition, asset managers monitor various liquidity risk indicators, such as the Asset Liquidity Indicator (ALI) or Turnover Ratios, to assess how easily assets can be sold or

traded without significantly impacting prices, especially under stressed market conditions. They also monitor real-time data regarding bid-ask spreads, trading volumes, and market depth to track liquidity levels in underlying assets.

Asset managers are required to establish contingency plans that outline strategies for addressing liquidity shortfalls in stressful scenarios. These plans must cover a range of stress events and provide clear frameworks for accessing liquidity, whether through cash reserves, liquid assets, or external sources.

Redemption and liquidity management policies are also crucial. In line with the AIFMD and UCITS, asset managers ensure that their funds have robust redemption policies in place, such as redemption gates and swing pricing mechanisms. These tools help manage large-scale redemptions during market stress and prevent the dilution of the remaining investors' holdings.

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?

The current regulations already provide NCAs and asset managers with tools to monitor and manage the liquidity profile of funds (see answer to question 16).

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

Calibrating worst-case and stress-case scenarios for redemptions and margin calls is complex due to the overarching uncertainty surrounding extreme market events, investor behaviour, and asset liquidity. The lack of historical data, unpredictable correlations, and dynamic market responses further complicate the process.

One of the primary difficulties lies in the inherent uncertainty of extreme market events, extreme tail risks and asset correlation. While historical data can offer insights, it will never provide a wholly accurate basis on which to model the future.

Predicting how investors, both retail and institutional, will react under extreme conditions is highly uncertain. For instance, panic-driven redemptions can be much larger than expected, and investors may behave in unpredictable ways.

In volatile markets, collateral values can fall sharply, triggering margin calls on leveraged positions. The timing, size, and frequency of these margin calls depend on both the market conditions and the specific terms of financing agreements. Due to these considerations, estimating the liquidity needed to meet margin calls during extreme scenarios is particularly challenging.

Regulatory constraints further complicate the calibration process. Limits on how quickly and in what amounts redemptions can occur, need to be accounted for when modeling

stress events. In addition, liquidity buffers or redemption gates may limit the speed of redemption flows, requiring adjustments to the models to reflect these realities.

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?

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

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?

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 NBFIs sector(s) you refer to in your answer?

MMF units should be allowed to be pledged directly as collateral. This would allow financial institutions to use the MMF units directly as collateral without having to sell them for cash first. This avoids the need for mass redemption of MMF units, which can create significant liquidity pressures and force the sale of assets at depressed prices. It would therefore provide a more stable and efficient use of assets, thereby reducing systemic risks associated with leverage. This is particularly relevant in times of market turmoil, when access to liquidity is crucial.

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 NBFIs sectors.

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?

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.

Currently, there are a wide range of different types of money market instrument (MMI) across the EU in various different markets such as ECP, STEP and NEU CO, each of which is successful in the market for which it was intended. We do not think it is practical – given the costs involved – to create wholly uniform EU MMIs and that the different types will continue to exist. However, there may be some merit in adopting a label to demonstrate that a MMI has certain attributes and, in particular, is eligible for asset purchase programs (to allow dealers to finance positions at times of stress). Current initiatives, such as the STEP initiative, already promote transparency and standardization effectively in the long-term. Since 2007, STEP-labelled instruments have qualified as collateral for Eurosystem financing operations, which has improved liquidity during periods of market stress and a more widely applicable label that other types of MMI could also adopt to guarantee that such MMI would also qualify for Eurosystem financing operations may be beneficial.

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?

Diversifying funding sources may benefit issuers, but from an investor's perspective, particularly for MMFs, it may not enhance financial stability due to a preference for high-credit-quality, frequently issued debt from larger issuers.

MMFs tend to favor issuers with strong credit ratings and frequent issuance, in line with regulatory requirements such as UCITS and MMFR. Smaller issuers, which are typically more opportunistic and issue debt less often, are less appealing to MMFs. Furthermore, MMFs are inclined to prioritize bank-issued commercial papers and certificates of deposit, as these are more abundant and regularly issued compared to those from smaller or non-financial issuers. As a result, while diversification benefits issuers, the inclusion of a larger number of smaller issuers may not have a significant impact on overall financial stability.

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.

The issuance of euro-denominated commercial papers in the EUR-CP market outside the EU is not considered a risk but rather a reflection of the global nature of this segment

of the short-term money markets. This global market provides significant benefits to issuers who can access a global investor base. It also has benefits for issuers domiciled outside of the EU but need access to Euro liquidity (such as access to capital even when European markets may be closed). From an investor perspective, the EUR-CP market is a large and deep market which offers attractive investment opportunities thereby enhancing liquidity for European money market investors, including MMFs, Central Banks, pension funds and global corporations.

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

Commercial papers and certificates of deposit have short-term maturities that hinder the development of a deep secondary market, and while transparency can improve, measures like relaxing dealer balance sheet constraints during market stress can help enhance secondary market trading of money market instruments.

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?

We see no reason for modifying the threshold.

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.

Other investors in CP include central banks, pension funds, insurance companies and corporate treasuries. As such, the investor base is more wide-spread than the question suggests. MMFs being significant buyers of CP is a positive factor as it provides valuable funding for issuers.

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?

Greater transparency and standardization across markets could attract new investors, thereby enhancing liquidity through a more diverse investor base.

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?

We are cautious about mandating the trading of money market instruments on trading venues due to cost implications and because, especially in the primary market, confidentiality is desirable for certain large transactions. However, market efficiency can

be improved through reforms like digitizing documentation and adopting shorter settlement conventions.

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)?

We believe that regulated venue trading will not replace existing market practices, which rely heavily on bi-lateral trading with dealers and issuers buying back their own CP. While regulated venues can provide additional transparency and potentially improve liquidity, they may not significantly increase secondary market activities during a systemic event. To enhance short-term funding markets, one potential area of research is the implementation of a standing repo facility for commercial paper and certificates of deposit withing the Eurosystem.

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.

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.

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?

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?

Emerging liquidity risks can affect other markets due to the interconnectedness of financial markets. A liquidity crisis in the corporate bond market can impact MMFs holding these bonds, causing redemption pressures. Similarly, disruptions in the repo market can affect short-term funding availability. The March 2020 market turmoil highlighted how liquidity issues in one market can spread to others, affecting overall market stability. In our view, non-regulated NBFIs pose a risk since NCAs cannot monitor their liquidity profiles, potentially leading to spillover effects during market stress.

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?

Leverage limits are sufficient.

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

Yield buffers for LDI funds can provide a safety net to meet margin calls, enhancing stability during market stress. However, they may reduce fund returns and increase operational complexity.

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.

The vast majority of OEFs do not employ significant leverage. Moreover, leverage is often deployed for reasons other than gaining additional exposure to an underlying market, including for efficient portfolio and risk management purposes. It cannot, however, be excluded that some leveraged investment funds may face steep liquidity demands during periods of stress. For this reason, supervisors should focus on these funds that are at greater risks of a liquidity shortfall due to sudden margin calls. NCAs already have the possibility to introduce leverage limits under the UCITS and AIFM Directives or maintain yield buffers for individual or group of funds to ensure the stability of leveraged positions. The revised AIFMD Directive introduces an absolute limit for loan originating funds. Therefore, EU regulated funds such as UCITS and AIFs cannot build up excessive leverage, contrary to non-regulated NBFIs.

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

Much of the information that EU regulators need to analyse macroeconomic risk already exists. In the EU, even richer data will exist after the introduction of the enhanced reporting regime under the AIFMD review. Therefore, the emphasis should be placed on better data sharing between supervisors rather than new reporting obligations for the regulated fund sector. Better data sharing can be achieved through ESMA becoming the EU data hub for capital markets. This would allow NCAs and the ECB to continue collecting supervisory data while allowing that this data is accessible by the other authorities that need this information. This would ensure that management companies would no longer have to report the same information to several authorities, especially during period of stress. It should also be considered how this data can be shared with firms as well, as for example useful for bank's counterparty risk assessment. The EU

should also explore the extent to which there are data gaps from non- or less-regulated NBFIs sectors that can be a source of systemic risk, such as big tech and crypto asset intermediaries, and consider policy intervention if this is determined to be a relevant gap. Such data gaps could be informed and identified by system-wide stress testing. As macroeconomic risk assessments cannot be considered on an EU basis alone, we would also support sharing of supervisory data and insights between EU and closely connected financial markets.

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

The EU should explore the extent to which there are data gaps from non- or less-regulated NBFIs sectors that can be a source of systemic risk, such as big tech companies and CASPS, and consider policy intervention if this is determined to be a relevant gap. Such data gaps could be informed and identified by system-wide stress testing.

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

Much of the information that EU regulators need to analyse macroeconomic risk already exists. In the EU, even richer data will exist after the introduction of the enhanced reporting regime under the AIFMD review. Therefore, the emphasis should be placed on better data sharing between supervisors rather than new reporting obligations for the regulated fund sector. Better data sharing can be achieved through ESMA becoming the EU data hub for capital markets. This would allow NCAs and the ECB to continue collecting supervisory data while allowing that this data is accessible by the other authorities that need this information. This would ensure that management companies would no longer have to report the same information to several authorities, especially during period of stress. It should also be considered how this data can be shared with firms as well, as for example useful for bank's counterparty risk assessment.

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?

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?

Rather than imposing new reporting requirements, we recommend that regulators enhance their use of existing data. Regulators have tools to monitor leveraged positions

via derivatives, particularly through the EMIR reporting framework in the EU, which tracks exposures, leverage, and concentration risks.

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?

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?

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?

We see merit in exploring system-wide stress testing to identify and understand vulnerabilities stemming from links between different NBFIs, and between banks and NBFIs, including in relation to the risk of amplification and herding behaviors embedded in large portfolio overlaps. However, it is important to take into account the limits of being able to model the whole financial system. System-wide stress testing should be focused on specific issues such as preparedness for margin calls. The FSB and IOSCO's planned work on system-wide stress testing may also facilitate cross border cooperation between authorities and understanding interconnectedness between players across borders. Therefore, the EU may want to defer its decision to establish a system wide stress testing before this exercise is complete.

As macroeconomic risk assessments cannot be considered on an EU basis alone, we would also support sharing of supervisory data and insights between EU and closely connected financial markets.

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.

Yes. If EU-wide financial system stress tests are to be pursued, NBFi supervisors and bank supervisors will need to put in place arrangement between themselves for sharing data. It is crucial to prevent banks and the regulated fund sector from having to report the same information multiple times to different supervisors, as this could lead to unnecessary burdens.

Furthermore, given that macroeconomic risk assessments extend beyond the EU, we would also support sharing of supervisory data and insights between EU and closely connected financial markets.

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?

We believe that the governance chosen for Fit-for-55 is interesting as it involves all relevant supervisors, covering banking, insurance and asset management. However, it is probably too early to opine on the merits of the approach as the exercise is not closed

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.

We support the creation of an enhanced supervisory coordination mechanism for the adoption of macroprudential measures for open-ended funds, such as leverage restrictions or powers to suspend redemption on financial stability grounds. While NCAs would remain responsible for their adoption given the specificities of each EU Member State's fund market, ESMA should liaise with NCAs and help coordinate their actions. For example, ESMA should make NCAs aware of macroprudential measures being taken by other NCAs and help them decide if they should adopt similar measures. More broadly, macro-prudential supervisors should also work with their micro-prudential counterparts, who have more intimate knowledge of those investment funds identified as potentially contributing to the build-up of systemic risks.

Enhanced coordination mechanism (implementation and adoption of NMMs)

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?

Much of the information that EU regulators need to analyse macroeconomic risk already exists. In the EU, even richer data will exist after the introduction of the enhanced reporting regime under the AIFMD review. Therefore, the emphasis should be placed on better data sharing between supervisors rather than new reporting obligations for the regulated fund sector. Better data sharing can be achieved through ESMA becoming the EU data hub for capital markets. This would allow NCAs and the ECB to continue collecting supervisory data while allowing that this data is accessible by the other authorities that need this information. This would ensure that management companies would no longer have to report the same information to several authorities, especially

during period of stress. It should also be considered how this data can be shared with firms as well, as for example useful for bank's counterparty risk assessment.

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

We support the creation of an enhanced supervisory coordination mechanism for the adoption of macroprudential measures for open-ended funds, such as leverage restrictions or powers to suspend redemption on financial stability grounds. While NCAs would remain responsible for their adoption given the specificities of each EU Member State's fund market, ESMA should liaise with NCAs and help coordinate their actions. For example, ESMA should make NCAs aware of macroprudential measures being taken by other NCAs and help them decide if they should adopt similar measures. More broadly, macro-prudential supervisors should also work with their micro-prudential counterparts, who have more intimate knowledge of those investment funds identified as potentially contributing to the build-up of systemic risks.

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?

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 NBFIs sectors or only for a specific one.

Supervisory powers of EU bodies

Question 62.1: 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?

Based on the explanations provided in the consultation response, we find no justification for increasing supervision of large asset managers.

Much of the information that EU regulators need to analyse macroeconomic risk already exists. In the EU, even richer data will exist after the introduction of the enhanced reporting regime under the AIFMD review. Therefore, the emphasis should be placed on better data sharing between supervisors rather than new reporting obligations for the regulated fund sector. Better data sharing can be achieved through ESMA becoming the EU data hub for capital markets. This would allow NCAs and the ECB to continue collecting supervisory data while allowing that this data is accessible by the other authorities that need this information. This would ensure that management companies would no longer have to report the same information to several authorities, especially

during period of stress. It should also be considered how this data can be shared with firms as well, as for example useful for bank's counterparty risk assessment.

Question 62.2: What could be ESMA's role in ensuring coordination and guidance, including with daily supervision at fund level?

We support the creation of an enhanced supervisory coordination mechanism for the adoption of macroprudential measures for open-ended funds, such as leverage restrictions or powers to suspend redemption on financial stability grounds. While NCAs would remain responsible for their adoption given the specificities of each EU Member State's fund market, ESMA should liaise with NCAs and help coordinate their actions. For example, ESMA should make NCAs aware of macroprudential measures being taken by other NCAs and help them decide if they should adopt similar measures. More broadly, macro-prudential supervisors should also work with their micro-prudential counterparts, who have more intimate knowledge of those investment funds identified as potentially contributing to the build-up of systemic risks.

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.

Refer 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)?

Question 65: What are the pros and cons of extending the use of the Enhanced Coordination Mechanism (ECM) described under section 6.1 to other NBFIs 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.

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?

International coordination

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

Generally, we note that the FSB and IOSCO's planned work on system-wide stress testing may facilitate cross border cooperation between authorities and understanding interconnectedness between players across borders. In light of this, the EU may want to defer its decision to establish a system wide stress testing before this exercise is complete.

Furthermore, the Commission should closely monitor the FSB work program on non-bank leverage, with policy recommendations to be published in a consultation report by December 2024. These recommendations must be aligned with the EU regulatory framework to ensure effectiveness within the European context.

Finally, there is a need for a harmonized definition of NBFIs. We believe the FSB's activity based categorization of NBFIs that create systemic risk, the "Narrow Measure", is a good starting point.

By adopting this focused definition globally, regulators can consistently identify and monitor NBFIs most likely to contribute to systemic risk. A standardized definition further allows supervisors to better trace these linkages. Without a harmonized definition providing a uniform standard leading to more balanced regulatory pressures, activities from less regulated entities may exploit gaps through regulatory arbitrage. Further alignment also facilitates smoother coordination and more cohesive regulatory policies globally.

From a data standpoint, the FSB's definition includes specific criteria for risk exposure, enabling regulators to collect consistent, comparable data on NBFIs worldwide to perform accurate risk assessments and stress tests that taking into account global exposure to similar types of non-bank risks. A harmonised definition would significantly improve transparency for investors, creditors, and counterparties, contributing to more informed investment decisions. The European Commission should also monitor approaches adopted in other jurisdictions that could provide learnings or models for the EU. A notable example is the Bank of England's Contingent NBFIs Repo Facility that would allow eligible NBFIs to borrow cash against gilts during severe market stress. While there would be challenges in replicating such a model at EU level or in the Eurosystem, establishing a dedicated facility for managing NBFIs liquidity during a market stress could be an effective means of preserving financial stability.