SwissFinanceCouncil
Fostering International Dialogue

SFC Position on NBFI consultation

The Swiss Finance Council (SFC) engages in dialogue around policy developments in finance at a European level. Our members, including among the largest global asset and wealth management firms, have substantial activities within the EU.

Swiss asset managers manufacture both Money Market Funds (MMFs) and Open-Ended Funds (OEFs) within the EU and manage and distribute them both within the EU and on a cross-border basis. Therefore, any changes to the EU macroprudential framework for MMFs and OEFs would have a direct impact on Swiss asset managers.

More broadly, given the interconnectedness of EU and Swiss markets, there is need for continued international cooperation on the Non-Bank Financial Intermediation (NBFI) agenda. This paper outlines our initial views on the European Commission targeted on the effectiveness of the macro-prudential framework for the NBFI sector.

High level considerations

- **EU fund sector is already highly regulated:** 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.
- **Fund sector as a whole is not systemically important:** As a starting point it should be established the extent to which systemic risks exist, and if they do, precisely define what they are. Targeted policy measures can then be proposed if necessary.
- **The investment fund sector is inherently diverse:** Many funds follow long-term investment strategies aligned with appropriate risk management practices that make them unlikely to contribute 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 corporate debt funds), it does not necessarily mean that these funds exhibit a liquidity mismatch.
- **There is a significant NBFI agenda outside the regulated fund sector:** 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 NBFI sectors such as pension funds, family offices and hedge funds. 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, alongside cash, as collateral for margin calls would limit the contagion during stress market conditions and contribute to financial stability.
- **Use existing micro-and macro-prudential tools to manage risks:** Investment funds do not need to ensure a perfect match between the liquidity of their assets and liability and can rely on liquidity management tools (LMTs) to manage unexpected redemptions. The uniform use of LMTs, as adopted under the AIFM/UCITS Directives' review, will contribute to macroeconomic stability. 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 for the purpose of macroeconomic systemic risk assessment

would also be helpful. At the same time, it should be considered how data can be shared with firms, as for example data that is relevant for banks' counterparty risk assessment.

Views on core elements of the consultation paper

1. Liquidity risks

Open-ended funds (OEFs)

The current EU UCITS and AIFM Directives already provide National Competent Authorities (NCAs) 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 OEFs.

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 liquidity management tools (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.

Money Market Funds (MMFs)

The 2023 European Commission report showed that the MMF Regulation fared well during the liquidity stress experienced by MMFs 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.

The European Commission did propose certain potential measures to further increase the resilience of MMFs. We do not see the need for increased liquidity buffers especially in VNAV funds. While the UK and US have recently increased liquidity buffers, we maintain the view that 50% weekly liquid assets as a share of total assets under management is unnecessary.

Instead, it would be preferable to delink 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. It is not feasible to increase liquidity buffers in the event of a system-wide crisis.

The common stress testing framework for MMFs is already extensive. MMFs undertake annual stress tests with parameters sets 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.

Given that short-term funding instruments are typically traded over-the-counter (OTC), it would be disproportionally expensive to require such instruments to be listed. Although typically liquid in ordinary market conditions, measures could be taken to improve the function of the short-term funding markets. This includes electronic trading platforms to enhance transparency and market

depth; less fragmentation and more harmonisation 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.

Leverage risks

Open-ended funds (OEFs)

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 limit for loan originating funds. Therefore, EU regulated funds such as UCITS and AIFs cannot build up excessive leverage, contrary to non-regulated NBFIs such as family offices.

Money Market Funds (MMFs)

MMF holdings should be allowed to be pledged directly as collateral. This would allow financial institutions to use the securities within the MMF as collateral without having to sell them for cash first.

This avoids the need for mass redemption of MMF shares, 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.

2. Develop an effective macroprudential framework

Asset managers operate in multiple countries, often by passporting the same fund or creating funds with similar characteristics in different EU Member States. Therefore, coordination in the supervisory action and in the use of micro- and macroprudential tools both within the EU and between EU and closely connected markets is key.

Enhanced supervisory coordination

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 other 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.

System-wide stress testing

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. System-wide stress testing should be focused on specific issues such as preparedness for margin calls. When specifically reviewing the investment fund sector, supervisors should also use more advanced analytical frameworks than those currently available.

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.

Better data sharing

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 NBFI sectors that can be a source of systemic risk, such as family offices, pension funds and sovereign wealth funds, 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.

International cooperation

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.