RESPONSE TO CONSULTATIONS

EUROPEAN COMMISSION

Assessing the adequacy of macroprudential policies for non-bank financial intermediation

alfi association of the luxembourg fund industry

1. KEY VULNERABILITIES AND RISKS STEMMING FROM NBFI

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?

In order to address and mitigate systemic risks, a prerequisite is to acknowledge that the models and underlying risks of various NBFI actors are tremendously different and sometime orthogonal. Even within the open-ended funds sector itself this diversity remains prevalent. As a consequence, the framework to design macroprudential policies needs to differentiate these activities/sectors and rely on an objective framework to specifically target pocket of vulnerabilities. A targeted rather than a catch-all approach has several benefits.

Firstly, it will avoid undue costs and resources spent on entities with minor impact on financial stability. Similarly, activities/sector/sub-sector with meagre financial stability impact would not bear the costs originating from macroprudential policies on behalf of other entities with a larger impact. A meaningful definition of impact relates to the externalities (unrelated to economic fundamentals) resulting from an activity onto financial stability. Yet, financial stability should not be mistaken with artificial price stability since price discovery, and associated price volatility, remains the tenet of well-functioning capital markets. Secondly, beyond efficiency, a targeted approach is needed to ensure effectiveness of the measure taken. Since macroprudential risk can arise from different sources, different tools are needed to effectively mitigate the risk. From this point of view, a clear distinction is to be made between balance sheet-based business and principal agent relationship-based businesses. The consultation briefly touches upon a similar notion under the semantic of 'principal-based business' and 'agent-based business'. The nature of the liabilities between these two types of activities strongly diverge and need to be acknowledged for the definition of appropriate tools.

Accordingly, the development of potential new or adjusted macroprudential tool needs to be targeted (e.g. sub-sectoral approach) and not via a brutal catch-all approach. An efficient targeting approach, would be facilitated by an identification of the activities with a major financial impact beyond fundamentals. Although the definition of an identification methodology is beyond the scope of this answer, two relevant criteria for this assessment are:

- The nature and intensity of the liability – *e.g. balance-sheet liability vs principal agent liability*
- The concentration of the liability owner and disposer – *e.g. with look through*

In conclusion, ALFI recognizes that pockets of vulnerability may exist and could arise in the future while stretching the need to acknowledge for the diversity of NBFI entities in terms of macroprudential risk. Accordingly, ALFI recommends to adopt an approach targeted to activities with the largest financial stability impact rather than a catch-all approach. ALFI further

recommends for the tools to be tailored to the nature of the activities targeted.

In addition to the conclusion, another source of risk remains unaddressed by the consultation. Besides financial risk, business risk is a relevant consideration for both the real economy and fostering EU citizens' savings and participation to capital markets. As of today, the main driver of business risk is competition: international (outside Europe) competition and investment vehicle types competition. The current political context entails regulatory divergence with non-EU countries. Although the virtues of regulation are fully acknowledged, countries outside Europe with lower regulatory pressure benefit from the capability to create investment product at lower costs and with more features (innovation). Costs and product innovation are the two essential pillars for developing competitive advantages outside Europe. Similarly, should regulatory pressure diverge too significantly between investment funds and other investment vehicles (e.g. mandates, pension products, …) a competitiveness differential would arise. Under this scenario, investments would flow outside the EU and into vehicles with potentially lower investor protection standards. Against this background, it is essential to draw the policy makers and supervisors' attention on the side effects of each regulatory developments, in an already robust industry, on competition, viability of European enterprises and products as well as on the access of EU citizen to capital markets. In this context, a through cost-benefit analysis to identify only essential regulatory changes is systematically required.

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.

Not answered

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.

Not answered

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.

Not answered

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.

Not answered

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

Not answered

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.

Not answered

2. OVERVIEW OF EXISTING MACROPRUDENTIAL TOOLS AND SUPERVISORY ARCHITECTURE IN EU LEGISLATION

3. OVERVIEW OF EXISTING MACROPRUDENTIAL TOOLS AND SUPERVISORY ARCHITECTURE IN EU LEGISLATION

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.

MMFs proved to be resilient since the entry into force of the MMFR, including during the onset of the covid-19 crisis. At the beginning of the pandemic, short-term European MMFs had weekly liquidity levels well above their regulatory minima and average liquidity levels for the whole first half of 2020 remained at around 50% (EFAMA, European MMFs in the Covid-19 market turmoil, November 2020). Furthermore, it should not be disregarded that the portfolio construction of MMFs organically has high levels of liquidity. Assets within the WLA will generate cash due to natural maturity schedule without the sale of any position. With this in mind, ALFI is of the opinion that the current system works well, so ALFI does not see the need to establish a fixed, increased liquidity buffer on a collective basis (i.e. a one-size-fits-all approach via an amended

regulation).

However, ALFI believes that there would be merit to provide the flexibility to adapt the daily and weekly liquidity buffers to current market circumstances in the interest of the investors. This option should be made available to the management of the fund which is best equipped to decide whether or not to make use of such flexibility at a given point in time. Alternatively, in very exceptional market circumstances, the regulator could also be empowered to provide such flexibility.

The last option should be seen as an ultimate last resort due to the strong limitations pertaining to this type of external management of the fund, including:

- The calibration of the appropriate liquidity buffer stems from a variety of factors. This includes among others, other assets liquidity level, prevailing market conditions, main liquidity providers inventory and appetite but also investors type and concentration, and the distribution operational model. These factors highlight how divergent can the appropriate liquidity buffer be for a priori looking alike funds. The determining factors demanding divergences are not necessarily well identified by external parties and more efficiently assessed by the manager.
- The identification of an externally imposed liquidity buffer too often collapses to a 'one-size-fits-all' calibration which inherently involves a certain degree of subjective and therefore potentially diverging judgements among the competent authorities. This subjective nature is perfectly illustrated by the Table 8 of the *Financial Stability Board ('FSB') Thematic review on MMF Reforms* displaying the significant variation between jurisdictions of the minimum liquidity requirements.
- The possibility to impose liquidity buffers inconsistently across the EU (individual basis) or global (collective basis) MMF industry would result in diverging liquidity profiles as imposed by supervisory forces rather than economic rational. Because of the inherent liquidity premium, such a divergence would translate into a noticeable performance differential relatable to the documented notion of 'cash drag'. Due to investors' strong preference for returns, such asymmetric situation in presence of investors' rational expectations could result in ex-post as well as pre-emptive reallocation across MMFs at the expense of the funds already under liquidity stress. Indeed, the benefits of increasing investors sophistication have been accompanied by more attempts from certain investors to anticipate on the liquidity management decisions. When a trigger for reallocation becomes too easily predictable the risk of such pre-emptive run increases. In this context, Li et al (2021) already evidenced the relationship between the MMF liquidity restriction and run. Stronger liquidity constraints could result in European asset managers offering a narrower range of products in the MMF space. A competitive edge lost on the regulatory ground would hinder competitiveness of EU firms with resulting real economy consequences.
- The wording of Question 8 implies the usage of liquidity buffer as a sort of Liquidity

Management Tool ('LMT') to be used in extreme condition. This is contrasting with the European views, that liquidity buffers, are not LMTs. This claim is supported by the recent AIFMD/UCITSD review establishing a list of basic LMTs from which two must be selected (Directive EU 2024/927 - Article 16.2b and 18a). This list revealingly does not include liquidity buffer as an LMT highlighting that other LMTs are widely available in Europe to manage redemption or other liquidity pressure.

As a conclusion, ALFI recommends that the adaptation of the level of the liquidity buffer remains a responsibility of the investment fund manager considering the limitations of an external intervention abovementioned. Due to these severe and impeding limitations, competent authorities should refrain from intervening in the liquidity buffer adaptation with the ultimate exception of investors' protection force majeure type of situations and with appropriate safeguards to limit the side effects of externally imposed buffers.

Li, L., Li, Y., Macchiavelli, M., & Zhou, X. (2021). Liquidity restrictions, runs, and central bank interventions: Evidence from money market funds. *The Review of Financial Studies*, 34(11), 5402-5437.

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 detailed in Question 8, the transfer of liquidity buffer adjustment (increase) power to competent authorities is not the preferred scenario. ALFI is of the view that this responsibility should remain within the remit of the investment fund managers. The rational supporting this case is provided in depth in Question 8.

Should this external intervention and transfer of power happen on the basis of an ultimate exception to address investors' protection force majeure type of situations, an efficient coordination mechanism should be focusing on reducing the asymmetry of information through existing data mutualisation as well as information and knowledge sharing. In this context, a streamlined data collection and analysis framework would support a pan-European alignment on the identification of emerging risks allowing informing decision-making in a timely manner. A structured accessibility of this already existing data and analysed information is a leverage to ensure consistency across authorities. On the other hand, the wide communication of the ESRB macroprudential analyses to the broad base of market participants (not solely authorities) would facilitate the assessment of systemic risks and the development of appropriate recommended measure.

In conclusion, ALFI recommends the coordination to be fostered on the information

mutualisation, transparency and accessibility. This refers to a pan-European existing data mutualisation and in the direction of pan-European knowledge sharing.

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?

MMF reporting is tailored to address the very specificities of MMF compared to other funds. This encompasses both economic and regulatory driven specificities. On the other hand, the new UCITS supervisory reporting obligations and improvements to AIFMD reporting aims at capturing comparable data for a less homogeneous group of funds strategy wise and regulation wise. The two-reporting frameworks fulfil different needs and have two different purposes:

- Providing comparable, yet detailed, information on a large universe of funds with diverging profiles for the new UCITS and AIFMD reporting framework.
- Providing tailor-made information to capture the specificities of a particular strategy and product for the MMF Reporting.

As a consequence, because the two purposes cannot be necessary reached at once, ALFI does not see a rationale to align UCITS and MMF reporting requirements.

In addition, in terms of potential improvement to the existing reporting framework, the reporting regime under normal and under stressed conditions should be distinguished. Under stressed conditions, more frequent and targeted reporting could be useful. This could be covered by additional ad-hoc reporting as needed. To our knowledge, the additional ad-hoc reporting that was introduced by some National Competent Authorities ('NCAs') (such as the IFM notification on fund issues and large redemptions that was launched by the Commission de Surveillance du Secteur Financier ('CSSF') in May 2020 and March 2022) at the onset of the pandemic proved to be very effective and useful to monitor developments.

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?

A review of the proposals reveals that the vast majority of the proposed tools are already existing within the regulatory framework or supervision practices as highlighted below:

- **Investor base and concentration**: ALFI is of the view that the existing "know your

customer provisions" under Article 27 MMFR (Regulation (EU) 2017/1131) already greatly support the better understanding of the nature of investors and anticipating their behaviour. This article echoes the 2018 IOSCO recommendations for liquidity risk management for collective investment schemes (FR01/2018), applicable to all collective investment schemes (beyond MMF), that establish investor base/concentration knowledge expectations (Recommendation 3, Recommendation 4, Recommendation 13, and in particular Recommendation 5). The IOSCO thematic review on liquidity risk management recommendations (FR13/22) showed that EU jurisdictions widely adopted these IOSCO recommendations by 2023 (see Box 1 page 3 for a summary). Some jurisdictions expressly adopted the recommendations such as Luxembourg via its CSSF Circular 19/733. The ESMA Guidelines on liquidity stress-testing in UCITS and AIFs (ESMA34-39-897 EN) also cover investor knowledge in Guidelines V.1.5 and V.1.12 (also implemented domestically as per the CSSF Circular 20/752). This increased regulatory guidance has been reflected in industry practices that have remarkably improved on the fund liability side. An illustration of this enhancement is the trending practices of gathering complementing investor information through global distribution networks. As such, the current framework already provides for the useful investor information to assess and manage liability liquidity risk. Furthermore, an essential distinction between investor information and investor transparency (in particular look-through) is to be made. While investor information, which can take several forms, is essential to manage redemption risk, transparency is not necessarily adding value. Indeed, in addition to be exceedingly costly and oftentimes unfeasible (depending on the distribution model), looking through the investor base does create data with limited informative relevance for redemptions management. Most of the efforts required are devoted to create investor information with non-material impact. The effort should focus on generating investor information with material impact and relevance. Such risk-based approach could rely on a variety of data, estimation techniques and processes which needs to be proportionate to the underlying risk. As an illustration, the case of distribution models with limited transparency but where the risk is mitigated by the fact that redemptions are systematically known prior to being placed is a vivid example. In conclusion, investor information should not be interpreted as and expected to equate to investor transparency and even less look-through.

- **Existing NCA stress test based remediations**: It has been observed that some NCAs have implemented a regular (yearly) liquidity stress testing data collection exercise from the investment fund managers and independent stress testing execution. Such exercises support the identification of outliers and are followed by bilateral analyses and remediation when appropriate. This NCA exercise is extremely efficient as the identification of outliers requires a one-to-one in-depth qualitative and quantitative analysis to confirm the presence of a situation to mitigate or to conclude on a false positive. This need for a local analysis is reinforced by the fact that a) liquidity metrics are only point estimates subject to model assumptions and model risk and that b) the

presence of a need for mitigation highly depends on the operational model and of qualitative information to be collected. For example, such approach is implemented in Luxembourg and is documented in the CSSF Working paper - Liquidity stress test for Luxembourg Investment Funds: the time to liquidation approach (Lô and Carpantier).

In light of the review, ALFI considers that the relevant regulatory infrastructure to reach an effective and robust stress testing framework is already in place. Accordingly, ALFI recommends to leverage and fully deploy the already existing tools and practices.

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 high-level nature of the intention shared in the consultation (bullet point 4 of page 18) regarding a prospective Union-wide stress test, leaves uncertainty regarding the design and operational model of such stress exercise. For example, the consultation does not clarify if this exercise would adopt:

- either supervisory scenarios performed by supervised entities' model; or
- stress simulations led by supervisors' model

as defined in the ESMA Economic Report – Stress simulation for investment funds 2019.
A clarification would be beneficial to execute and document a complete analysis of the impact and benefits of this measure.

In absence of more specifications and details, the high level and prima facie pros and cons are the followings:

- **Benefit 1** – An EU-wide stress test would introduce a new set of metrics to identify liquidity risk which were previously not used unanimously.
- **Benefit 2** – A consistent approach to stress testing across member states would be ensured.
- **Benefit 3** – An external scenario definition reduces the interpretation and modelling specification costs as well as the resource intensive need to validate internally the relevance of the scenario.
- **Cost 1** – Significant costs would be associated with developing and maintaining an EU-wide stress testing framework.
- **Cost 2** – An EU-wide stress test would result in an increased operational burden on MMFs to comply with additional stress testing requirements.
- **Cost 3** – The scenarios may, by legacy, overly rely on the banking regulations/practices, not adapted to the nature of MMFs (which are not leveraged for instance like the banks) and not adapted to the specificity of the market in which they are investing.
- **Cost 4** – Catch -all-scenarios are likely failing at capturing the specificities of each sub-strategy, operational and distribution model. Furthermore, due to the time changing nature of market and liquidity risk (at the level of the asset and main liquidity provider),

scenarios are exposed to frequently grow ill-calibrated (shock size) or even become outdated (scenario relevance).

ALFI recommends to better specify the Union-wide stress testing and consult stakeholders on the basis of a clearer blueprint. ALFI further recommends to adopt a proportionate approach considering the benefits and costs associated with the exercise.

Reverse distribution mechanism

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

The introduction of the ban has triggered efforts from the EU MMF industry to adapt to this requirement in a context of negative interest rates for several currencies. At the time, this move triggered numerous discussions and comments from industry associations and market participants. The industry concerns related to changes of approved and long relied upon operational procedures, divergence with other global MMF hubs, and confusion created amongst already existing investors. A trend observed at the time was the departure from the CNAV format towards other non-constant NAV formats to allow for the negative yield to be captured by the changing NAV. After this initial and substantial adaptation of the operational model, the industry has reached a new model allowing compliance with this prohibition stemming from the level 1 MMFR. Views are now, once the costs integrated, more nuanced. For example, some participants consider that, once the resource drain internalised, the ban could enhance the stability and integrity of MMFs by preventing practices that could undermine investor confidence. And that it also promotes greater transparency and fairness in the MMF market.

It is nevertheless relevant to highlight that no regulatory convergence has been achieved on this topic across the globe since the reverse distribution mechanism is maintained in the US after the MMFR reform and in other jurisdictions.

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 described in Question 13, after a substantial alternation of the operational model, the industry has reached a model allowing it to operate without recourse to reverse distribution.

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.

Initiatives promoting issuance and transparency are supported. Transparency is an important factor in our market and, with this view, some of our members support initiatives (like the STEP market) that aim at increasing market standard. Nevertheless, it is critical to recall that there is no de facto link between transparency and liquidity. The market liquidity of an instrument depends on other predominant factors (including among others, quality of credit, size of the issuer, currency of issuance, structure of the asset) and marginally in comparison on transparency. In particular, admission to trading has limited impact on liquidity during market stress where all trades are going in the same direction. As a consequence, the admission to trading does neither guarantee nor imply a mechanical increase of liquidity.

In absence of such causality, ALFI recommends that regulatory requirements for MMFs do not consider whether the instrument is admitted to trading on a trading venue or not since it is an insufficient and vastly noisy proxy (sometime misleading) to gauge the instrument liquidity.

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?

From an industry perspective, investment fund managers appear to be subject to monitoring along the following practices:

- **Application for approval** – For supervised funds, representing the main investment vehicles for financial assets, the application for approval process includes an ex-ante assessment of the liquidity and risk profile of the fund. As an illustration, in Luxembourg, this assessment by the CSSF is traditionally done on model portfolios where liquidity information is required to assess the viability of the liquidity asset-liability model and mitigate the liquidity mismatch risk. This answer focuses on liquidity, but the approval assessment encompasses a larger set of factors such as leverage and sub-asset class specific risks. For manager-supervised funds, a common model for private assets, this pre-launch assessment is carried out by the manager to fulfil its economic and regulatory obligation under the NCAs supervision.
- **Semi-annual reporting** – In addition to the pre-launch analysis, the liquidity of the fund is also monitored on an ongoing basis through the semi-annual UCITS Risk reporting as implemented by the CSSF since 2016. The "full scope reporting", (where all information are required from the IFM) covering routinely around 80% of the asset under management of all Luxembourg domiciled UCITS authorised by the CSSF, includes asset (liquidity buckets) and liability (redemption, shareholders type and concentration)

liquidity information as well as LMTs (availability and use) information. This periodic exercise supports the CSSF in its identification of potential mismatch in a dynamic manner.

- **Ad-hoc liquidity data request** – It has been observed that NCAs also rely on their entitlement to request data in order to monitor position level liquidity. For example, for several years, on a sampling basis, the CSSF has requested position and liquidity data from investment fund managers for targeted funds. This large-scale exercise is repeated yearly and the liquidity assessment of the IFM is reviewed and challenged when necessary. The working paper mentioned in Question 11, from (Lô and Carpantier) provides information on this exercise and illustration on how it is effectively used to monitor liquidity mismatch risk (CSSF Working paper - Liquidity stress test for Luxembourg Investment Funds: the time to liquidation approach).

In addition, it is relevant to emphasise that in order to leverage on the three tools abovementioned the CSSF developed internal data analysis and local industry expertise to collect information, to consume information and to challenge results.

Against this background, ALFI is convinced that the supervision model as implemented is robust and appropriate in addressing liquidity mismatch risk. On the other hand, ALFI considers that opportunities for improvement in monitoring open-ended funds liquidity profile lie in the coordination of pan-European existing data mutualisation. Indeed, as detailed in Question 43 and 57, pan-European existing data mutualisation would enhance liquidity monitoring in a convergent and consistent way. This proposition is not limited to liquidity and is the most efficient and effective way to promote convergence. The synergy of mutualised existing data (Annex IV and ECB) allowing timely and efficient information access across NCAs combined with the increased attention and local expertise of NCAs supervision would result in a heightened capability to identify vulnerabilities in a prompt and consistent manner.

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?

Not answered as specifically directed at NCAs/EU bodies

Question 18. What is the data that you find most relevant when monitoring liquidity risks of OEFs?

Since the liquidity related regulatory uplift, often associated with a 2017/2018 pivot (FSB, IOSCO, ESMA), market participants have significantly enriched their monitoring toolbox with a larger range of liquidity data. Although relevant liquidity information can take various forms due to the varying specificities of market infrastructures on which different asset types are exchanged,

some frequently mentioned data types are listed below:

- **Asset liquidity** – is generally captured with proxy data for the complementary size and costs aspects. Size is often proxied with a) transactions volume data and b) costs with bid-ask spread and c) price impact data. One legacy of the pivot was to refocus the attention to price impact in stress conditions when volume becomes less relevant.

In this respect, the industry sophistication has also grown in term of understanding, interpretation and challenge of this data. In particular, liquidity risk managers now prominently acknowledge that most liquidity metrics are only point estimates generate by models. Therefore, these data points are model dependent and only proxies since the true liquidity level is not directly observable. Furthermore, as highlighted by Fong et al (2017), there are several methods to compute these estimates. Accordingly, investment fund managers do not only rely mechanically on these estimates but analytically review them in light of underlying liquidity determinants and complement them with real time market facing agent information.

- **Redemption liability liquidity** – is generally captured via flow and investor base data. Again, as explained in Question 11, investor base data should be distinguished from investor transparency or look-through. The relevant investor base information is to be defined proportionately to the costs and redemption risk in light of the distribution model. The flow data provides with relevant and rich historical dataset. Both flows of the actual funds or proxies ('peers') are used. The investor base data, generally a snapshot, complement flows with a forward-looking perspective. Investor type (including domicile among other) and concentration are two relevant criteria.

Similarly, to asset liquidity, the market participants' attention to the determinants driving redemption behaviour has also increased. In addition, participants have increasingly reached out to their distribution network for additional supplementing information.

- **Other liability liquidity** – is generally captured via liabilities originated from financial derivative instruments through market stress test results to monitor the level of plausible margin requirements. As another form of other liability, the security lending extent is also traditionally closely monitored.

Fong, K. Y., Holden, C. W., & Trzcinka, C. A. (2017). What are the best liquidity proxies for global research?. *Review of Finance*, 21(4), 1355-1401.

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

Not answered as specifically directed at NCAs/EU bodies

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?

In term of liquidity management, a pivotal contribution of the AIMD/UCITSD review is to ensure the wide availability of LMTs across EU via the Annex V and Annex IIA. Furthermore, the mandate provided to the ESMA by the EU Commission in the Article 16(2)(g) and (h) and 18a(3) and (4) of the amending Directive (EU) 2024/927 fulfils this need to deal with potential inconsistencies or insufficient calibration between the LMTs selected. In particular, the RTS format for definition and the Guideline format for calibration appears well fitted for the ambitioned purposes.

On the other hands, it remains ALFI views that, the fund board should be responsible for the (de-)activation and calibration of LMTs albeit with regular and timely reporting on as to how it is responding to changing market circumstances. NCAs should not be involved in the day-to-day management, but only intervene in exceptional circumstances (e.g. systemic risk posed to funds or asset classes as a whole). Instead of imposing the activation of LMTs, the provision of advice by the NCAs could be considered (e.g. already when setting up the fund, it should be analysed and determined which LMTs could be considered based on the characteristics of the fund).

Regarding the capacity of NCA to ensure the action of investment fund managers, ALFI believes that the provisions in the AIFM (Directive 2011/61/EU) and UCITS (Directive 2009/65/EC) Directives provides NCAs with all necessary tools and power to do so. In particular, Article 46 (AIFMD) Article 98 (UCITS) details in which ways NCAs power can be exercised. This list contains potent supervision leverages such as authorisation withdrawal. Furthermore, Article 48 (AIFMD) and Article 99 (UCITS) also sets the ground for the establishment of an administrative penalty regime and the possibility for competent authorities to publicly disclose them. Repeatedly, ALFI believes that the existing framework provides NCAs with an appropriate toolbox to ensure supervised entities action.

For completeness purposes, in the context of LMTs selection, usage, and calibration, another omitted critical incentive relates to market discipline. Indeed, the investors scrutiny on LMTs related items is high and supported by appropriate disclosure from the industry. In this context, it has been observed that preserving reputation is a central consideration for investment fund managers when designing their LMTs policy.

In conclusion, ALFI considers that the original and updated UCITSD and AIFMD frameworks are already appropriate to address the needs in term of LMT calibration consistencies and enforcing in a coordinated way LMT adjustments when needed.

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

In the post IOSCO recommendations / ESMA Guidelines era, investment fund managers have increasingly used early warning indicators. From a modelling perspective, deterioration of estimates under stress conditions is a general feature of model-based forecasts. Since liquidity measurement is inherently based on modelled estimates due to the non-observable nature of liquidity, monitoring should take this possible model risk into account. In order to mitigate this risk and validate or adjust estimates during stress, investment fund managers are increasingly making use of alternative information including more qualitative information from market facing agents. The parallel use of alternative information of different nature and from different sources has proven to be a powerful tool under stress conditions.

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?

As mentioned, liquidity measurement and monitoring practices have been subject to a major uplift after 2017/2018. In this journey, the industry has overcome several difficulties leaving investment managers in a notably better situation today. Some intrinsic challenges that persist are the following:

- **Model risk** – liquidity modelling, especially price impact, is notoriously subject to model risk. Because liquidity is essentially unobservable, it requires modelling. Indeed, the uncertainty around liquidity point estimates is large especially at time of evaporating liquidity. This uncertainty and model risk arise from the low signal to noise ratio in liquidity data as well as the highly non-linear relationships (see Roncalli et al, 2021 for additional technical background) between volatility and its determinants. This uncertainty is to be considered and an additional critical analysis is to be carried out when monitoring liquidity risk on the basis of model driven metrics.
- **Intermediated distribution network** – Intermediated distribution networks allow investors from different countries to access similar products and enhance their investment opportunity set while avoiding a product range captivity. On the other hand, this implies that investment fund managers rely on potential different intermediation/distribution channels for the same fund. As a consequence, investor data depicts some level of non-standardisation. Investment fund managers have worked to streamline the processes with intermediaries (distributors, platforms, etc). This

nevertheless entails a resource intensive coordination and data reprocessing undertaken by investment fund managers.

Since the above list does not try to be exhaustive, other challenges may be raised such as the consistent execution of the liquidity monitoring through the entire fund life cycle or the liquidity specific features of some securities. While strategy, operational model or manager specific hurdles exist, the two items relate a widespread feedback and provide an industry wide view.

Roncalli, T., Cherief, A., Karray-Meziou, F., & Regnault, M. (2021). Liquidity Stress Testing in Asset Management--Part 2. Modeling the Asset Liquidity Risk. *arXiv preprint arXiv:2105.08377*.

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

Redemptions – Echoing the answer to Question 21, over the last 7 years the industry has extensively enhanced its redemption risk monitoring capabilities. In light of this progress, two challenges have emerged. The first challenge refers to the unstructured and scattered nature of the investors data already mentioned (for details refer to Question 21) that poses a data management and resource constraint. The second challenge refers to modelling. Thanks to better information collection and management efforts, defining unconditional worst-case and stress-case scenarios – *worst scenario irrespective of any market conditions* – has become a rather straightforward and value-adding risk management exercise. On the other hand, conditional scenarios – *worst scenario given some prevailing conditions (performance, risk, liquidity, etc.)* – accounting for the time changing investors sensitivity to different factors remains a technical challenge. Indeed, such exercise often results in unstable scenarios introducing a trade-off between capturing dependencies and relying on scenarios stable enough to inform management actions.

Margin calls - Around the 2017/2018 pivot, some shortcomings were observed regarding margin call scenarios as illustrated in the Common Supervisory Action ('CSA') feedback from ESMA (item - Quality of LRM mechanisms and methodology) and CSSF (item - Coverage of liabilities other than redemptions). However, these weaknesses related to the coverage of margin calls within the liquidly risk management framework rather than to the technical difficulties associated with the measurement exercise. Indeed, the margin call scenario calibration and impact assessment are tightly linked to standard market risk management practices that have been long established. Accordingly, taking into account the feedback, the industry has swiftly and smoothly reused their standard risk engine and practices to serve the purpose of liability liquidity modelling. In this regard, capturing margin call into the liquidity scenarios presented a limited challenge to the industry.

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?

Not answered as specifically directed at NCAs/EU bodies

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?

Not answered as specifically directed at NCAs/EU bodies

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?

Not answered as specifically directed at NCAs/EU bodies

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?

Not answered

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.

Not answered

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.

Not answered

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?

Not answered

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.

Not answered

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?

Not answered

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.

Not answered

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

Not answered

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?

Not answered

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.

Not answered

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?

Not answered

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?

Not answered

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)?

Not answered

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.

Not answered

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.

Not answered

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?

Not answered

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?

Not answered

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?

First of all, one must highlight that leverage is a broad term. Leverage in itself does not necessarily translate into financial stability risk. The nature of leverage and underlying risk factors need to be differentiated. Some forms excessive leverage may pose threat to stability while many other forms allow diversification or even hedging for investors including retails. A single leverage figure cannot make such distinction.

The current toolbox, including but not limited to the AIFMD Annex IV and Article 25, has proven effective in mitigating systemic risk from leverage. Beyond this macroprudential tool, other constitutive elements of the EU funds regulatory framework play a meaningful role in leverage risk mitigation. This is notable the case of risk management provision from UCTISD and AIFMD including among others global exposures (VaR, leverage), stress testing, liquidity risk assessment, risk profiling and disclosures. As mentioned, supervisory activities, either at the fund level or manager level, is also a central element to contain leverage driven systemic risk.

In this respect, the European fund management framework provides for a robust and transparent regulatory framework and it is critical not to confuse it with other less regulated NBFI activities. As a matter of illustration, in the context of leverage, the consultation refers to the Archegos anecdotal evidence. It is valuable to stretch that this entity was not regulated or supervised as a fund or fund manager (neither US nor EU framework) and that this case study cannot therefore be extrapolated to the fund industry. Furthermore, this consultation tackles systemic leverage (physical) from the borrower side. However, from an incentive perspective, addressing this risk from the lender side is essential. The lender is the entity compensated for the risk undertaken and is the entity pricing this risk. As risk owner and incentivised by the risk-reward trade-off, the lender is actively building on or scaling down systemic leverage as an economic agent.

Furthermore, as rightfully stated in the consultation, the level of leverage amongst EU open-ended fund is moderate. The observed fair leverage level within the industry is an evidence of the effectiveness of the available toolbox. This claim is substantiated by supervisory data and statistics such as the CSSF UCITS risk reporting dashboard or the ESMA Market report on EU alternative investment funds 2023. For example, the former provides the entire leverage distribution beyond the average figures and also for a breakdown per factor.

The previous paragraph underlines the existence of an important tool to identify and contain systemic risk: existing data mutualisation and availability. While the possibility to limit leverage is available to NCAs, access to information on realised leverage is essential for monitoring and informing consistent supervisory decision-making. Similarly, to the answer to Question 9, a strengthened pan-European existing data mutualisation, would support an alignment on the identification of emerging risks allowing informing decision-making in a timely manner. An accessibility of this existing and collected data is an instrument to ensure consistency across authorities. This transparency tool is critical for convergence. Divergence in the allowed level of leverage usage creates disparity in the range of products (e.g. NewUCITS) made available to investors. As a consequence, leverage also becomes a topic of competitiveness both within the EU and globally.

In conclusion, ALFI considers that the tools available are effective and are supporting sustainable leverage landscape with EU open-ended funds. To enhance this framework, ALFI recommends the identification of emerging risk to be encapsulated within an existing data mutualisation in the direction of increased knowledge sharing.

Question 44. What are, in your view, the benefits and costs of using yield buffers61 for Liability-Driven funds, such as it was done in Ireland and Luxembourg, to address leverage?

Although the LDI yield buffer has been reported as a resource intensive and non-negligible process, the benefit of the initiative mainly lies in the fact that it was differentiated and tailored to the LDI fund model and underlying risk. The scope of the following answer is broader than the Question 44 alone. The industry broadly acknowledge that some pockets of vulnerability may exist in this diverse and fast-moving environment. Accordingly, the European Commission initiative and consultation is welcomed to address these pockets of vulnerabilities that can have significant reputational and economic impact on the entire NBFI sector.

For more details on the need for an objective identification methodology allowing to target and tailor the response to true pocket of vulnerabilities, please refer to Question 1.

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.

Please refer to the answer to question 43 for the set of tools enabling the effective monitoring of leverage and to the resulting moderate level of leverage in the EU open-ended funds sector. As detailed, the appropriate additional tool to further develop is an existing data mutualisation allowing efficient collection, storing and access to existing data across NCAs.

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

Repeatedly, building on the answer to Question 43, the level of leverage in the EU open-ended funds landscape is moderate. This claim holds for average value but also for the entire distribution of leverages as shown by the UCITS risk reporting dashboard either in the detailed realised leverage figures or sensitivity figures (e.g. stress tests).

Regarding the detection of leverage achieved through complex investment strategies, the principle of look-through reinforced by old (such as conversion to equivalent underlying market position for synthetic leverage) or newer (such as capturing exposure within legal structures controlled – Question 8 – Q&A Application of the AIFMD) guidance allows for a convergence of leverage computation methods. Although some isolated discrepancies can be observed at time, the overwhelming majority of the regulated funds and managers rely on computation methods capturing leverage under its different forms.

Finally, indirect leverage can either be a market risk amplifier or a credit risk amplifier. In a situation with limited liability, the former applies as gain and loss are amplified (or leveraged) without resulting in a greater loss than the NAV of the fund. In absence of limited liability, both market and credit risk amplification apply. The two cases have different systemic and chain consequences and need to be differentiated.

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

Not answered

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

Not answered

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?

Not answered

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?

Not answered

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?

Not answered

4. 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?

The existence of prominent interconnections across institutions and sectors is widely acknowledged and recognized. Connections between asset owners, asset managers, liquidity providers and other agents are deeply rooted in the structure of financial markets. As such interconnectedness is not a frailty but a prerequisite for well functioning capital markets. The weak link in such a connected environment would be the unmitigated and unsupervised ones. Currently, the supervision of many of the NBFI mentioned has improved to the point of reaching an effective framework for stability. As stated, the NBFIs listed or covered on the consultation are traditional and long-established financial models that benefit from decades of regulatory and supervisory evolution.

Regulators are a part of this interconnectedness. The institutional economics rationale calls for acknowledging that regulation creates incentives driving entities behaviour in certain anticipated but also unanticipated ways. The impact of regulation should also be considered in

discussions on interconnectedness within the ecosystem given the role it can play in driving market participants' behaviour. Potential side effects of regulations and unanticipated consequences have materialised in the past and raised policy (macroprudential or not) makers' attention. The MMF reform is a vivid illustration of those regulatory byproducts such as runs resulting from the mechanical link between LMTs activations and breach of liquidity requirements. This paragraph accentuates that the impact of new regulations and macroprudential tools are compelled to be included in the discussions on interconnectedness.

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?

Market participants are increasingly using stress tests and are comfortable with this risk assessment tool at the micro-level. When looking at the macro-level, it appears that stress testing can, in principle, be a helpful tool to assess main trends and dynamics, but this requires proper calibration of the targeted market segment or activity along with an appropriate methodology to reflect that. This would provide for meaningful results on market infrastructure and behaviour across specific scenarios based on comparable data across sectors. Therefore, for the system-wide stress tests to add value, it is of paramount importance to identify the right design, calibration (target) Moreover, a critical point is how the results are used by authorities. As such, the industry support to the proposal is conditioned on these elements and on the below:

- **An information collection exercise tool** – To remain effective in the context of heterogeneous activities within the population of NBFIs, the exercise should remain an information collection one and not result in mechanically triggering macroprudential policies, entity level rules or singling out entities. For example, while the EU system-wide stress test implies the execution and evaluation of similar stress scenarios across financial sectors, resulting macroprudential measures should remain distinct across sector. This differentiation is required as the underlying systemic risks, although connected, remain innately different. By way of illustration, credit institutions have a systemic risk connection via their balance sheet. On the other hand, the vulnerability of the funds sectors lies in potentially misaligned principal-agent relationship. The two sources of risk are addressed by fundamentally different tools. A balance sheet business vulnerability can be mitigated with capital buffers. A principal-agent business vulnerability is addressed with reducing asymmetry of information, aligning incentives and independent controls including the fiduciary role of the board of the fund and/or manager. On the whole, stress test results-based measures should not be extrapolated from one financial sector, such as credit institution, to another. But the measures should be adapted to the nature of the vulnerabilities.
- **A tool that allows calibration to specific targets** – for system-wide stress tests to

deliver meaningful results a specific target each time is needed in relation to the market segment, types of asset classes and/or risks which permit a proper calibration of the methodology. As already seen in the recent regulatory experience in the UK such a targeted approach with a relevant calibrated methodology can deliver data on comparable activities, investment strategies or asset classes and in that way a allow for a meaningful understanding of the relevant market and an identification of potential gaps.

- **A tool to be complemented** – Stress test design involves a trade-off between scope and relevance. On the one hand, standardised scenarios allow all entities to rely on the same shocks to assess an across sector-wide impact. On the other hand, micro-level (e.g. fund level) stress tests allow to rely on scenarios fitting the particular risk profile of each and every entity capturing the idiosyncrasies of each activity and entity. The latter, pinpoint the key vulnerabilities while standardised framework might be not sufficient to reveal specific risk exposures. In these circumstances, an EU system-wide quantitative exercise cannot uncover alone systemic weaknesses. As such, the EU system-wide stress test should not be used to make assumptions and inferences on firms' behaviour or impact onto financial stability. Indeed, due to the heterogeneity of the risk exposures and complexity of the connections between different financial intermediaries, complementing a quantitative assessment with a qualitative analysis is a necessity. In this respect, the benefit of a such analysis depends on the use of the results rather than on the stress exercise itself.
- **A resource aware design** – Market feedbacks point to the resource consuming aspect of similar system-wide initiatives. Costs, time and opportunity costs (decreased attention on other relevant matters) have to be considered for the design of the exercise. In this respect, frequency is a relevant parameter. And it appears that a yearly exercise would not be proportionate in light of the costs induced and benefits generated. The consultation provides high level information on how would EU system-stress results be used but remains silent on the details. Such level of information does not allow to assess the benefit brought by this resource intensive exercise. Subject to this uncertainty, ALFI would like to emphasize that an EU system-wide exercise needs to be proportionate to the benefit it generates.

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.

Not answered

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?

Not answered

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)?

Within the investment fund management industry, we see have seen the development of across funds stress tests. This practice was, among other factors, fostered by the Guideline V.1.16 of the ESMA Guidelines on liquidity stress-testing in UCITS and AIFs. However, the relevant criteria for determining which funds will be pooled together for stress-testing purposes is not necessarily the affiliation to a group (e.g. asset manager). The relevant criteria are:

- **The dependencies of the liabilities** – Such as investors with similar profile and redemption behaviour
- **The dependencies in portfolio transactions** – Such as correlated trades on overlapping holdings across two funds

This notion of relevance is introduced into the Guideline specifically stating:

> *"A manager should aggregate LST across funds under its management where it assesses such an activity to be appropriate for those funds."*

For the second bullet point, it is important to stretch that affiliation to a group, fund family, Chief Investment Officer is not necessarily relevant as different portfolio manager have independent mandates and can have effectively very divergent transactions pattern. On the other hand, if a co-dynamic has been empirically observed or is created by the design of the portfolio managers' mandate and product feature, carrying out stress at pooled level instead of fund level is becoming a standard practice for liquidity stress-testing purposes. Other risk factors are less subject to overlapping impact and are less frequently subject to such manager level exercise. Nevertheless, the infrastructure to do so exists and can be deployed in case a risk is identified and justifies the resources.

5. SUPERVISORY COORDINATION AND CONSISTENCY AT EU LEVEL

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.

Convergence is a central priority for an effective and well-functioning union of financial services but also for reaching societal goals considering the infamous level of under participation of EU citizens in capital markets. In this line ALFI firmly supports convergence initiatives. Conversely, ALFI resolutely diverges with the idea that convergence equates with single supervision or even

stronger centralisation of supervisory power.

Firstly, a more centralised supervision would be completely ineffective in dealing with diverging national rules that remain the prime source of market fragmentation. For example, the daily operations of investment fund managers are ingrained with national rules pertaining to contract law, taxation, insolvency law just to name a few. Not only would a central supervisor not be able to solve for this fragmentation, but in absence of local supervisory expertise, a central supervisor will result in less efficient supervision cognisant of local specificities.

Secondly, although the consultation states local supervision as a prospective antecedent of fragmentation, it does obfuscate its benefits. The virtue of local supervision lies in a reinforced risk management framework (including macroprudential) owing to a) increased attention and b) tailored expertise. Supervisory attention is a limited resource that is empirically allocated on a risk-based approach basis resulting in uneven level of attention to different supervised entities. Some entities may receive more attention than other entities on the basis of criteria that are not necessarily the sole determinants of macroprudential risk. With the presence of local supervisors this limited attention problem is reduced with proximity and the smaller number of entities per supervisor. As a matter of illustration, the Security Exchange Commission ('SEC'), a single supervisor, operationalises its supervision through 10 regional offices. Beyond proximity and attention, some NBFI sectors commonly rely on Ricardian type of specialisation across locations to reach more efficiencies. Under these circumstances, different locations entail different supervisory expertise because of the diverging models and underlying risks. This is typically the case for the fund sectors where different locations specialise in different distribution models (cross border distribution vs network captive product), product features (active vs passive, financial vs real asset) or ownership structures (third-party vs in-house). Different skills and experience are required and have been developed by some NCAs over time forming centres of expertise.

Unlike legal scholars who favour centralised supervision on the premise of theoretical models, empirical economists and academics reach more nuanced conclusions highlighting the benefits of a calibrated mix of centralisation and local supervision. For example, Hirtle, Kovner & Plosser, (2020) find empirical support for this attention hypothesis within each federal reserve district for banks. Similarly, Gopalan, Kalda and Manela (2021) show that the closure of a bank regulator's field office leads to the distancing of supervised entities and worsening economic output (leverage and risk of failure increase). In Europe, Altunbaş, Polizzi, Scannella & Thornton (2022), evidenced that the European Banking Union had a positive impact on disclosure. On the contrary, the associated Single Supervisory Mechanism ('SSM') resulted in a weakening of risk disclosure for by SSM-supervised banks relative to banks supervised by national authorities.

In addition to the two previously stated limitations to centralisation, considerations must be given to the immeasurable resources required to establish a more centralised supervision

mechanism (human and knowledge repatriation, knowledge building, administration, etc). Based on the disproportionate relationship between the resources needed and the benefits obtained, ALFI believes that more efficient tools and roles for the ESAs exist to reach the needed higher level of convergence. An alternative common supervision model is proposed in Question 58 and relies on a a) pan-European existing data mutualisation scheme, b) NCAs coordination network, and c) products centre of expertise.

Hirtle, B., Kovner, A., & Plosser, M. (2020). The impact of supervision on bank performance. *The Journal of Finance*, 75(5), 2765-2808.

Gopalan, Y., Kalda, A., & Manela, A. (2021). Hub-and-spoke regulation and bank leverage. *Review of Finance*, 25(5), 1499-1545.

Altunbaş, Y., Polizzi, S., Scannella, E., & Thornton, J. (2022). European Banking Union and bank risk disclosure: the effects of the Single Supervisory Mechanism. *Review of Quantitative Finance and Accounting*, 58(2), 649-683.

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?

As urged in Question 44 and 53, different NBFI sectors and different business models within the sector require different supervisory models to be effective. Once again, the fundamental differences between credit institutions and fund managers need to be emphasized. This claim does not imply that the fund sector is immune to systemic risk. However, this risk is different and is more appropriately mitigated by other measures than the ones tailored for the banking industry. A mere copy paste or a framework inspired by the banking supervision model would prove ineffective and could even leave substantial risks unaddressed for the fund sector and investors.

The two converse models, balance sheet-based business versus principal-agent business, create contrasting liabilities. Banks liabilities emanate from their role in public saving transformation. Fund managers liability relates to their promises to investor in terms of fund profile, liquidity and valuation. The latter must therefore focus on investor protection through a) reducing asymmetry of information, b) aligning incentives and c) ensuring independent control. Unlike a standardized capital requirement based macroprudential framework, these investor protection instruments also require greater coordination but also proximity and local expertise.

Furthermore, within the fund industry, the supervision is further reinforced by the fiduciary duty carried by board members as detailed in Question 59. In this frame of reference, ALFI believes that the optimal approach to achieve convergence of the fund regulatory and supervisory framework lies in two enhancements.

- **European data mutualisation** – EU open-ended fund supervision has become increasingly more data driven with disparity across jurisdictions. Considering the large heterogeneity of regulated entities and products as well as the pace of innovation within the sector, data driven regulation is the foremost tool of the macroprudential arsenal. Yet, the insufficient mutualisation of existing data across Europe may cause redundant usage of resource, delayed supervisory actions and less than perfectly aligned supervisory actions. The rationalisation and mutualisation of existing funds data allowing timely access to NCAs would provide for a solution for convergence, efficiency and costs reduction. This proposal is particularly relevant in the context of the current fund data framework overhaul including the UCITSD and AIFMD review (Article 20 and Article 24 respectively) and the ECB Regulation on statistics on investment funds (EU 2024/1988). Leveraging on these recent regulatory developments, the mutualisation of already existing information, including Annex IV reporting and investment funds ECB reporting, constitutes an essential tool for both efficiency and convergence. From an investment fund manager perspective, a streamlined data model and processing would avoid duplication for managers operating across jurisdictions. For NCAs, access to similar information would reduce analysis time and accelerate reaching a common supervisory position on the basis of objective and complete information. With the Annex IV and investment funds ECB reporting high quality and granular data already exists and result from significant industry efforts. Yet an infrastructure to mutualise and share this resource across NCAs is absent. A pan-European mutualisation scheme of already existing data is the required stepping stone of convergence ensured by a NCAs coordination network.
- **NCAs coordination network** – Building on the rational introduced in Question 57, proximity, attention, and expertise, convergence should be achieved through a network of better connected local NCAs. As detailed in the previous paragraph, data access would be an important infrastructure for connection. In order for this infrastructure to be used consistently, the establishment of a NCAs coordination network increasing the exchange and cooperation between NCAs would be an efficient and very influential tool to align supervisory practices under normal and stressed market conditions. The ESAs could be the fora for discussion among regulators with the aim of fostering a coherent approach to regulation, supervision and enforcement (e.g. Supervisory Coordination Network).

Beside these two central elements, other tools could be revisited such as the sequencing of the Lamfalussy process that has already supported convergence and could be further improved.

In conclusion, ALFI recommends to enhance convergence through the combination of a pan-European existing fund data (Annex IV and ECB reporting) mutualisation and a NCAs

coordination network.

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

As introduced and detailed in Question 58, the costs associated with an enhanced coordination based on more centralised supervision are extremely sizeable and also uncertain (subject to overshooting). For example, the necessary resource reallocation or knowledge creation for more central supervisors would entail significant costs to just duplicate already existing supervisory assets (human and physical). Furthermore, as detailed, such costs would not necessarily result in better supervision and could even decrease the quality of supervision in some aspects relating to product expertise and local law expertise. There are currently some inefficiencies. However, those would not be resolved by a supervision power transfer but rather by the approach detailed below. Accordingly, both costs and effectiveness should be accounted for. Such a double criteria assessment has led to the recommendation formulated in Question 58.

In addition to the details laid out in Question 58, the fiduciary structure of the asset management industry has to be underlined as a key element to protect investors and financial stability. Indeed, in addition to the safeguards and control functions in place, the board of the fund and/or investment fund managers carry the legal responsibility to act solely in the best interest of investors. This additional protection mechanism compared to other sectors and typical to investment funds provides for a robust extra stability mechanism. The macroprudential measures should be developed with respect to the residual risk after the mitigation of the fiduciary structure and not with respect to the unmitigated risk. Accordingly, the macroprudential and microprudential measures should acknowledge for the already existing mitigations and safeguards without duplicating them at high costs ultimately born by investors.

Accordingly, ALFI recommends to develop a strong NCAs coordination network powered by an EU data mutualisation scheme of the existing reporting (Annex IV and ECB) rather than enhanced coordination mechanism on the basis of effectiveness and costs considerations. Beyond effectiveness and costs, this design is useful for supervision quality with respect to cross-border products that need reinforcing centres of existing expertise and leaving product expertise to NCAs.

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?

This can be ensured per the design proposed in Questions 58 and 59 relying on a pan-European mutualisation scheme of existing data and a strengthening of the NCAs coordination network relying on local product expertise. See details on the referenced questions.

In addition, it is acknowledged that a macroprudential measure in one jurisdiction can have an impact in another. And it is believed that the current and existing framework (e.g. ESAs and ESRB) already provides for the sufficient infrastructure for coordination. The introduction of the yield buffer on GBP LDI funds is a recent example of cooperation between the CSSF and Central Bank of Ireland ('CBI').

As detailed in Question 57, each jurisdiction is unique as per its national laws (contract law, taxation, insolvency law, etc) and product specialisation. Accordingly, a one-size-fits-all NMMs would fail to capture this background leading to both inefficiencies and incapability to mitigate risks because of locally inappropriate sets of measures. As detailed, the current framework already provides the NCAs with sufficient tools for coordination and communication. Enhanced information sharing could further strengthen this collaboration in a data driven supervision era.

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.

Yes, as detailed in Question 58 and 59 by relying on a pan-European existing data mutualisation scheme and a strengthening of the NCAs coordination network relying on local product expertise. See details on the referenced questions.

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?

The costs discussed in Question 59 would be exponentially amplified in case of a specific "large asset manager" regime. Firstly, legal barriers would arise with this form of direct supervision as new fund structure/regime would have to be created for those asset managers (large or opting in depending on the final proposition). This would entail going through the framework design process that took place for decades in a context where supervisory and asset manager resources are limited. This reallocation of resources could even distract attention from pressing and emerging systemic risk issues. In addition, investors' confusion could be caused by this new regime. As stipulated in Question 53 and 58, reducing asymmetry of information toward investors is a key objective to mitigate risk in the fund industry. Accordingly, the proposed change would play against this priority.

Another consideration regarding the creation of a "large asset manager" status is the risk it poses to the level playing field across managers. While the ambition of the consultation is to foster convergence, this sort of "parallel regime" would run the risk of a differentiated treatment of market players (even for virtually similar funds), hindering competitiveness and fairness.

Finally, the absence of definition of what is meant by "large asset manager" reveals the lack of clarity of the alleged risk to be mitigated. As in many occasions mentioned in this consultation, NBFIs are not a homogeneous group. Some are regulated and supervised such as open-ended funds others are not. The liabilities stemming from the diverse business models are not comparable (even within the fund sector) and the supervision and macroprudential tools should be adapted and focused on the objective sources of severe vulnerabilities. To reach this goal, an objective and methodical assessment has to be carried out in light of the size/nature and concentration of these liabilities (look-through accounted for). For example, the size of an asset manager appears to be a poor proxy for the intensity of the risk created by liability and concentration. This notably highlights that the consultation, although mainly addressing open-ended fund under the generic NBFI name, is silent on the difference between product and manager regulatory frameworks which is however an essential tool. A disproportionate focus on a given sector with respect to the actual level of financial stability risk, could further create an incentive for regulatory arbitrage and for investors to shift towards less visible and regulated spaces.

As a conclusion, ALFI recommends to develop an objective systemic risk assessment method, as in Question 44, to assess the vulnerabilities of different NBFIs (and within sector) and to focus on key pocket of truly vulnerable sectors or sub-sectors with the appropriate tools. ALFI further recommends not to adopt a "large asset manager" regime but to enhance the risk-based approach by providing guidelines and principles supporting this assessment.

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 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 Question 62.

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 NBFI sectors?

Not answered

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.

Not answered

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?

Not answered

International coordination

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

Not answered