AMIC
Asset Management & Investors Council
The buy-side voice of ICMA

ICMA
International Capital Market Association

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

ICMA AMIC response to the European Commission consultation paper

Introduction

ICMA welcomes this opportunity to comment on the European Commission's consultation on *Assessing the adequacy of macroprudential policies for Non-Bank Financial Intermediation (NBFI)*. This paper represents an ICMA – wide consultation response, led by the Asset Management and Investors Council (AMIC) Committee and incorporates feedback from the broader ICMA membership.

ICMA is one of the few trade associations globally that includes both buy-side and sell-side representation. ICMA's buy-side members include asset managers, institutional investors, private banks, pension funds and insurance companies, among others. ICMA's buyside members are represented via its dedicated buyside constituency – the Asset Management and Investors Council (AMIC).

ICMA promotes well-functioning cross-border capital markets, which are essential to fund sustainable economic growth. It is a not-for-profit membership association with offices in Zurich, London, Paris, Brussels, and Hong Kong, serving over 620 members in 70 jurisdictions globally. Its members include private and public sector issuers, banks and securities dealers, asset and fund managers, insurance companies, law firms, capital market infrastructure providers and central banks. ICMA provides industry-driven standards and recommendations, prioritising three core fixed income market areas: primary, secondary and repo and collateral, with cross-cutting themes of sustainable finance and FinTech and digitalisation. ICMA works with regulatory and governmental authorities, helping to ensure that financial regulation supports stable and efficient capital markets.

Table of contents

Executive Summary

Key vulnerabilities and risks stemming from NBFI

- NBFI ecosystem is very heterogenous and a bank like uniform macroprudential framework is not appropriate.
- Systemic liquidity risks are likely to arise from NBFI entities and activities that are not subject to the same degree of regulatory obligations and visibility as the highly regulated investment funds, pension funds and MMFs.
- The collapse of Archegos highlights the need for a system-wide cross-border systemic counterparty risk monitoring performed jointly by authorities (market authorities, banking supervisors…), to prevent similar crises. Authorities are (and should remain) the only stakeholders able to obtain the full picture of the trades and positions of any given market participant necessary to conduct such monitoring. Current regulation already provides for a significant amount of data (e.g. EMIR reporting obligations) which can be leveraged to that effect. If used and shared appropriately among EU regulators and supervisors, this would enable a better understanding and limit the reporting burden and data requirements on market participants (banks, asset managers etc). Ultimately, we recommend that regulators and supervisors enhance cooperation among relevant authorities across jurisdictions (including in the EU), and invest into dedicated data analysis capacities. This complements the existing reinforcing initiatives of bank's counterparty credit risk management initiated at Basel and EU levels.
- The current central clearing requirements, and specifically the requirements to use only cash as collateral to meet variation margin calls may have procyclical effects causing selling pressure of assets during periods of stress, to meet these margin calls. This concern is equally valid for non-cleared derivatives transactions.
- We consider that the current central clearing collateral requirements should be reviewed so that high quality assets (particularly MMFs, government bonds and other high-quality securities) are recognised as eligible collateral, alongside cash, for meeting variation margin calls, which would help ease liquidity stress and limit any contagion risks.
- Regulatory barriers impeding the uptake of CCP sponsored models to support access of non-banks to centrally cleared repo should also be removed as this can provide an additional option for NBFIs to access liquidity, as well as for banks to serve their clients in a way which is less resource intensive.
- It is important to note the importance of non-bank participants in the bond markets who are also key sources of liquidity. Hedge funds, in particular, are increasingly becoming a key element of bond market dynamics, particularly in the rates space.
- A more direct economic role for non-banks is through the provision of private lending. Importantly, given the shifting shape of the economy, and the requirement for more SME-focused funding, private credit, along with private equity, is likely to play an ever-increasing role in the capital market ecosystem.

Overview of existing macroprudential tools and supervisory architecture in EU legislation

- Asset managers and investment funds are already governed by very robust regulatory frameworks which have also been recently reviewed and enhanced at both EU and global levels.
- The potential for liquidity mismatches in OEFs has also been extensively addressed by existing regulations and more recent reviews at both EU and global levels.
- The existing EU MMF requirements already impose rigorous rules and stress testing requirements. Empowering authorities to increase liquidity buffer requirements in times of stress embeds procyclicality effects.
- Standardisation of CP markets is a valuable ambition which could expand and deepen market participation. This could leverage off existing markets, so long as the design is correctly calibrated to create a clear regulatory framework that ensures transparency and efficient post-trade processes.

- Increased transparency by way of a fully consolidated, publicly available source of information that provides a holistic view of the CP market would be helpful. However, disclosure of pricing transparency might lead to misinterpretation of issuers' financial health, business operations or funding strategies.
- Issuers and investors generally adopt a buy-to-hold strategy with CP, which for various reasons is unlikely to change. Consequently, CP trading in secondary markets is limited, with liquidity largely sustained by dealer banks repurchasing previously issued paper, which is likely to continue. While incremental measures could enhance secondary market liquidity, each should be evaluated carefully for potential benefits as well as unintended consequences.

Excessive leverage

- Excessive leverage is not a concern within the regulated NBFI sector due to existing leverage caps, specific reporting requirements and supervisory intervention powers.
- To deal with leverage of NBFIs that are not currently included in EU legislation, the focus should be on developing the effective monitoring and supervision of these NBFI entities through market surveillance, and cooperation, by way of a system-wide cross-border systemic counterparty risk monitoring (to be conducted jointly by authorities, i.e. market authorities and banking supervisors); leveraging existing data as a priority to avoid any additional burden.

Monitoring interconnectedness

- The issue is not the links between banks and NBFIs, but how these exposures are monitored and mitigated when necessary. Greater availability of data will benefit both market participants and supervisors to better understand the risks in term of financial stability.
- Enhanced oversight, including supervisory collaboration and data sharing should be prioritised to facilitate supervisors and regulators identification of any vulnerabilities and mitigation of any risks relating to the interconnectedness.

Supervisory coordination and consistency at EU level

- We do not consider there to be a need for greater intervention powers to manage crises of asset management companies as NCAs already have direct intervention powers, applicable to EU funds and their managers, as well as coordination obligations. Existing coordination mechanisms for OEFs are sufficient and have demonstrated their effectiveness, for example through the use of Article 25 of AIFMD.
- Instead of the introduction of an Enhanced Coordination Mechanism (ECM) and a list of National Macroprudential Measures (NMMs), the focus should be on facilitating data sharing between the NCAs and ESAs which could be achieved through the creation of a single regulatory reporting data hub.
- Supervision should be applied consistently across all management companies and not be determined by size – management company size is not an appropriate risk metric.

Concluding remarks

- As financial markets are global by nature, having a European-limited approach may fail to properly address the concerns expressed so far by EU policy makers. Imposing new rules on EU players will not solve systemic risk sources coming from the "less known and less monitored" entities domiciled outside the EU.
- Any macroprudential policies should facilitate NBFIs roles as liquidity providers without imposing excessive burdens that risk hindering their key role of financing the real economy. This balance is essential to achieve the EU's competitiveness enhancement objective in the next five years.
- NBFI ecosystem is very heterogenous and a bank like uniform macroprudential framework is not appropriate – the review and analysis should consider the entire ecosystem and not lead to increased regulation for the sectors which are already subject to very robust regulatory frameworks.

- In addition to Archegos, there are other examples of non-bank failures, none of which resulted in a systemic failure of the financial system. The common theme is an absence of data related to underlying risk, including leverage and interconnectedness, either at the counterparty or supervisory level related to these "less known and less monitored"[1] entities, as well as more widely regarding the knowledge of such non-bank profiles. Accordingly, it is not clear how a standard macroprudential framework would have been the most effective means of avoiding such specific incidents.
- Enhanced data sharing between ESMA, NCAs and the central banks through the creation of a single regulatory reporting data hub is a key measure to help identify regulatory gaps, support in developing targeted policy responses and enable a more holistic view of players in the market.

1 By "less known" and "less monitored", we specifically mean the NBFI entities and activities that are not subject to the high level of regulatory obligations and monitoring as investment funds, pension funds and MMFs.

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?

The GFC revealed financial stability risks exacerbated by the central role of banks in the financial system which resulted in the strengthening of macroprudential frameworks. This included the introduction of capital buffers, liquidity requirements, stress testing, regulation of systemically important institutions, and tools to curb excessive credit growth and leverage.

The NBFI ecosystem is extremely heterogenous in the nature of the entities and the activities that it captures, and thus a bank like "one-size fits all" framework should not be considered to address any potential future shocks such as the shocks specifically mentioned in the consultation paper (Archegos).

Past experiences have demonstrated that some sectors, and activities, within the NBFI ecosystem have vulnerabilities which have caused market disruption. It is important to identify these very specific vulnerabilities and risks and come up with adequate measures to address them.

In the specific case of the regulated entities in the NBFI universe, such as asset managers and investment funds, we do not consider their specific activities to be a source of systemic risk given the regulatory framework they operate in where they are fully known by regulators (from the start, through the delivery of licenses) and then monitored on an ongoing basis, until possible enforcement and sanctioning actions.

However, considering the regulated entities interconnectedness with banks as well as other less known and less monitored NBFIs, there are a number of vulnerabilities that should be addressed:

1. The interconnectedness with entities whose activities are not directly regulated (such as Archegos):

- The relevant counterparties, in this case the banks, are legally required and responsible for conducting thorough due diligence and in managing their counterparty exposures. However, banks are not in a position to obtain the full picture of a market participant's position necessary to monitor and prevent an Archegos-type failure. This is because this information is usually privileged and a market participant will most likely not volunteer this information, and certainly not with the required level of details. This would also raise compliance issues, where banks would potentially be collecting information on the competition (i.e. positions that the market participant has with other banks). **It is therefore up to the authorities (i.e. market authorities and banking supervisors) to complement bank's existing counterparty risk management frameworks by ensuring an effective monitoring of the systemic counterparty risk posed by the less monitored NBFIs to the financial system.**
- The NBFI entities which are used as an example in the consultation paper (such as Archegos) are not subject to the level of regulatory visibility as investment funds, pension funds and MMFs, and are subsequently not known and therefore directly not monitored by the supervisors. **Increased regulation, monitoring and greater data collection of these lesser known entities, would facilitate supervisors and central banks, to identify any specific vulnerabilities and make an informed assessment on how to mitigate them.**

Moreover, **securities regulators should aim to reinforce their existing market surveillance, through which they can get direct or indirect access to all information related to market activity of the lesser known[2] NBFI players.**

2 By "less known" and "less monitored", we specifically mean the NBFI entities and activities that are not subject to the high level of regulatory obligations and monitoring as investment funds, pension funds and MMFs.

2. Enhancing collateral efficiency in centrally cleared markets:

A way to reduce the occurrence of systemic risk on financial markets, or at least to reduce the occurrence of amplification of a financial market turmoil, would be to reduce the "dash for cash" for answering variation margin calls in both centrally cleared and bilateral markets.

The current central clearing requirements, and specifically the requirements to use only cash as collateral to meet variation margin calls, may have procyclical effects causing selling pressure of assets during periods of stress, to meet those variation margin calls. This may cause further unintended shocks and amplify market volatility. Alternatively, firms may rely on the repo market as a vehicle for transforming securities into short-term cash in order to meet margin requirements. However, in times of heightened volatility or stress, banks are often forced to shrink their balance sheets, reducing their intermediation capacity for what is a capital intensive / low return activity: meaning that the repo market cannot necessarily be relied upon as a source of ready liquidity during such market stresses.[3] This is also the case around regulatory reporting dates, such as calendar year-end.[4]

We consider that there are two significant improvements for consideration:

1) Expanding the scope of eligible assets to be used as collateral:

We consider that authorities should facilitate the use of MMFs[5], and well as other high-quality assets (investment grade government bonds and other high-quality securities) as eligible collateral, alongside cash, for meeting variation margin calls on centrally cleared and bilateral markets. This could significantly help ease liquidity stress and limit any contagion risks. As seen during times of liquidity stress, including during the March 2020 "Dash for Cash" episode, cash needed for collateral has been redeemed from MMFs only to be reinvested into MMFs (or a similar money market assets).

Thus, enabling MMFs, government bonds, or other high-quality securities, to be posted directly as margin collateral would mitigate this procyclical pressure and thereby contribute to overall systemic resilience. The importance of reviewing eligible collateral requirements is further supported by the interim results of the Bank of England's System Wide Exploratory Scenario (SWES) test. The SWES provides the BoE with new information on the behaviours of NBFIs and banks during stressed market conditions and it revealed in the first round (in November 2023) that 90% of liquidity requirements came from margin calls (80% from variation margin and 10% from initial margin)[6].

2) CCP sponsored models as additional tool for NBFI's to access liquidity

CCPs have developed sponsored models to address banks intermediation issues. These models provide an additional option for NBFIs to access liquidity, as well as for banks to serve their clients in a way which is less resource intensive. This addresses both the need of NBFIs to access liquidity on cleared markets to fulfil collateralisation or transformation needs, and the need to free-up banks' balance sheet capacities. Yet, benefits stemming from those additional clearing membership models can only materialise if the overall regulatory framework reflects their existence and their specificities.

That being said, it must be noted that the sponsored clearing models for repos have struggled to take off as clearing member banks have historically been reticent to become sponsors, a limited number of custodians are providing this service, and market pricing for cleared term repos (as opposed to bilateral term repos) is not economical which negatively affects demand for Sponsored models (noting that the ability to trade term repo is critical for funding and risk management and therefore for market resilience). To the extent possible, we would support some of these barriers to be eased (e.g. the addition of more sponsors and custodians) would be welcomed.

3 The European repo market and the Covid-19 crisis, ICMA, April 2020
4 Closed for Business: A post-mortem of the European repo market breakdown over the 2016 year-end, ICMA, February 2017
5 https://www.icmagroup.org/assets/documents/Regulatory/AMIC/ICMA-AMIC-MMF-CP-FINAL-300621.pdf
6 Financial Stability Report June 2024

While removing barriers to non-bank central clearing for repo would provide clear benefits, it also needs to be remembered that this also comes at a cost to sponsored clients relative to bilateral repo, which needs to be assessed against any additional benefit from enhanced liquidity. There are also potential procyclicality risks related to (cash) variation margin. ICMA and its members would therefore support improving access to and incentives for non-bank repo clearing models but would strongly advise against any moves to mandate non-bank repo clearing.

If the objective is financial stability and access to liquidity in period of stress to strengthen European capital markets, then a holistic review of the regulatory framework pertaining to NBFIs needs to be undertaken to significantly increase the attractiveness of CCP clearing.

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.

The most significant risks for credit institutions do not stem from their exposure to regulated NBFIs. Any significant risks stemming from the interconnectedness with the less monitored NBFI sector can be contained by authorities complementing credit institutions' existing counterparty credit risk assessment obligations with a system- wide cross-border systemic counterparty risk monitoring.

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.

NBFIs are key providers of liquidity to the real economy and are essential when other channels are disrupted. For example, during the March 2020 turmoil, MMFs played a critical role in providing liquidity and based on an IOSCO Board-Level Financial Stability Engagement (FSEG) survey, all redemptions were honoured, no MMFs had to suspend redemptions, impose fees and/or gates, or had to convert from LVNAV to VNAV[7].

It is also important to consider how some less or non-regulated entities (or jurisdictions) could disrupt the financial system in the case of failure. One example featured in the Consultation Paper is of Archegos Capital Management.

To understand how a family office caused a loss of over $10bn to the financial system it is important to consider the following factors: i) data on balance sheets/holdings for some entities such as family offices is not readily available. ii) data on leverage (both supplied and demanded) also is not readily available. And iii) some derivatives exposures, such as total return swaps (TRS), are not reported in client information filings.

Archegos positions in TRS have since been reported to have been leveraged by a multiple of 5, according to people familiar with the family office[8]. This means borrowing $4 for every invested $1.

In a TRS, typically a bank owns the asset and transfers any returns to the investor, in exchange for a fixed-rate payment from the investor to the bank. In case the asset total return is negative, the investor will have to pay to the bank, the incurred losses in addition to the fixed rate payment. As mentioned, the bank is the owner of the asset, and the investor's name will not appear in any filings, providing anonymity to the investor.

Archegos Capital Management managed to obtain several leveraged TRS positions, with multiple banks, and due to a lack of transparency, these banks were not aware of each other's exposure to Archegos[9].

In addition to this, due to the holdings of Archegos Capital Management being "hidden", banks were not able to properly establish that its positions were not sufficiently diversified and mainly concentrated to a few names[10].

7 OR03/2020 Money Market Funds during the March-April Episode - Thematic Note (iosco.org)
8 How Bill Hwang of Archegos Capital Lost $20 Billion in Two Days - Bloomberg
9 https://www.ft.com/content/b7e0f57b-3751-42b8-8a17-eb7749f4dbc8
10 https://www.finma.ch/en/news/2023/07/20230724-mm-archegos/#:~:text=Overall%2C%20the%20bank%20incurred%20enormous,because%20it%20was%20not%20diversified

When some of these positions lost value in the market, Archegos was not able to meet margin calls[11]. As a result, banks started to liquidate these positions, driving the price of these assets down even more in turn.

In the aftermath of these events, the effects on the real economy and the financial system were profound, resulting ultimately in the collapse of Credit Suisse and losses of over $10bn amongst leverage and TRS suppliers. In addition, Archegos net worth of $20bn was wiped out, while Credit Suisse, facing losses in excess of $5bn as a direct consequence, collapsed. As well as causing losses to equity and AT1 bond holders, this is predicted to affect Swiss GDP for years[12].

But when we look more closely at Credit Suisse's losses arising from Archegos, it becomes clear that this was the direct result of both supervision (stress tests etc.) and institutional failures both with respect to due diligence and risk management. According to Credit Suisse's own analysis of events,[13] "the Archegos default exposed several significant deficiencies in CS's risk culture, revealing a Prime Services business with a lackadaisical attitude towards risk and risk discipline; a lack of accountability for risk failures; risk systems that identified acute risks, which were systematically ignored by business and risk personnel; and a cultural unwillingness to engage in challenging discussions or to escalate matters posing grave economic and reputational risk. The Archegos matter directly calls into question the competence of the business and risk personnel who had all the information necessary to appreciate the magnitude and urgency of the Archegos risks but failed at multiple junctures to take decisive and urgent action to address them."

There are other examples of non-bank failures, including SAC Capital, Long Term Capital, and Amaranth. **All of these cases are relatively unique with respect to their specific causes, including fraud. But the common theme is the lack of data, in some sectors of the NBFI universe, related to underlying risk, including leverage and interconnectedness, either at the counterparty or supervisory level, as well as knowledge on companies' profiles.** However, none resulted in a systemic failure of the financial system, nor is it clear how a standard macroprudential framework would have been the most effective means of avoiding such specific incidents.

Further, by contrast we note that the adoption, implementation and recent reinforcement of AIFM and UCITS Directives avoided similar issues in the EU, both because EU asset managers and investment funds have to be licensed and monitored later on by securities regulators, and also because EU asset managers and funds have to regularly report their activities, fund by fund, to securities regulators (as well as to central banks in the eurozone).

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.

Given the current licensing as well as depth of monitoring and reporting concerning the regulated NBFI entities and activities, systemic liquidity risk is most likely to materialise in the activities which are less monitored and are less known.

In order to effectively manage any potential systemic liquidity risk, there needs to be greater monitoring and oversight over the less monitored or non-regulated entities and activities where systemic risk is most likely to materialise.

Given that these entities are not currently subject to the same monitoring and reporting requirements as the highly regulated NBFIs and banks, it is important that authorities complement banks' due diligence and counterparty risk assessments with a system-wide cross-border systemic counterparty risk monitoring. The Archegos collapse might have been mitigated if authorities were equipped with monitoring tools allowing detection of concentrated positions spread across several banks. On an individual basis, most banks have been able to close out properly and without losses, reflecting efficient collateral and risk management practices. Credit Suisse on the other hand, suffered a significant amount of losses as a result of 1) the concentration of the Archegos' positions across the banking industry amplified by 2) serious and well-documented shortcomings in its risk management, at odds with industry best practices.

11 A margin call is a request by the lender (or supplier of a leverage), requiring the borrower to deposit more cash as collateral.
12 https://www.reuters.com/business/finance/credit-suisse-collapse-threatens-switzerlands-wealth-management-crown-2023-03-22/
13 Credit Suisse Group Special Committee of the Board of Directors report on Archegos Capital Management by Paul, Weiss, Rifkind, Wharton & Garrison LLP, July 2021

Bond markets

Specifically, to bond markets, this topic was already investigated by ICMA in its 2023 report: *Liquidity and resilience in the core European sovereign bond markets*[14]. The report is based on extensive data and quantitative analysis as well as interviews with market participants, including market makers and investors.

Generally speaking, liquidity in sovereign bond markets is good. But in periods of stress liquidity evaporates rapidly. Liquidity provision during times of heightened volatility usually becomes concentrated among the larger banks, as many broker-dealers are forced to reduce their balance sheets (potentially giving rise to concentration risk), and as a direct consequence of banking prudential regulation. Furthermore, dealers tend to restrict their liquidity provision to their larger and more profitable clients. The report concludes that there is a trade-off between higher levels of bank capital and market liquidity, particularly in times of stress and heightened volatility.

Hedge Funds

Also noted in the report is the importance of non-bank participants in the bond markets who are also key sources of liquidity. Hedge funds, in particular, are increasingly becoming a key element of bond market dynamics, particularly in the rates space. At a meeting of ICMA's Secondary Market Practices Committee in September 2024, TradeWeb presented data that showed that in 2024 hedge funds account for more than 50% of Euro Government Bond (EGB) activity (compared with less than 30% in 2018), with the number of hedge funds active in that market increasing by 40% since 2018. Much of this can be attributed to higher yields, the end of distortive monetary policy, and advancement in trading technology and market data.

Importantly, and in contrast to many "real money" investors, hedge funds generally pursue relative value ("RV") strategies, focused on the price differential between securities or instruments, rather than taking directional views. Common strategies include positioning bonds versus IRS (swap spreads), bonds versus futures (basis trades), or bonds versus bonds, such as curve trades or credit spreads. The key consideration is that these strategies involve both buying and short-selling securities, regardless of market direction, and accordingly can provide a ready flow of two-way liquidity as well as countercyclicality in times of one-directional market moves. It also needs to be recognised that not all Hedge Funds are alike, and will pursue different investment strategies. This not only enriches and deepens the liquidity they provide, but it means that they should not be viewed as a homogenous investor type that respond to market moves or opportunities in the same way or at the same time.

This is discussed in a September 2024 ECB blog[15], which acknowledges the important role of foreign investors, most prominently hedge funds, in absorbing the increased net supply of EGBs. While the ECB highlights concerns that the employment of leverage by hedge funds could raise risks of amplification in the case of market volatility, they currently find no evidence to support this. Using repo data as a means to identify hedge fund activity (noting that hedge funds use the repo market extensively to finance both long and short bond exposures), the ECB observes an inverse relationship between hedge fund leverage and underlying market volatility.

Also noted by the ECB, hedge funds are reliant on banks' balance sheets to support their investment strategies, particularly through the provision of repo liquidity. Accordingly, the ability for such funds to acquire leverage is contained by already strict capital rules imposed on banks.

Both the ECB blog and the ICMA 2024 report note the inherent risk in hedge funds filling the void of traditional bank broker-dealers as a result of regulatory related balance sheet constraints, in that unlike primary dealers or market-makers there is no commitment for alternative liquidity providers to continue trading in times of stress, who can withdraw from the market without notice. This may be a more important concern than such funds contributing directly to market volatility, since this could have implications for real money funds who would otherwise be reliant on the ability of traditional bank broker-dealers as the primary source of market liquidity.

14 ICMA_BMLT_Liquidity-and-resilience-in-the-core-European-sovereign-bond-markets_March-2024.pdf (icmagroup.org)
15 Hedge funds: good or bad for market functioning? (europa.eu)

ETFs and Principal Trading Firms

Similar to hedge funds, principal trading firms (PTFs) also provide an alternative source of market liquidity through their trading strategies. This is most visible in the market for fixed income exchange traded funds (ETFs), particularly for credit (corporate bonds). Alongside bank broker-dealers, PTFs can act as Approved Participants (APs) in the ETF market, which are essentially ETF market-makers. However, unlike bank broker-dealers, PTFs are less capital constrained.

An important part of the AP role is the creation and redemption process of ETF trading. This involves a simultaneous transaction with the ETF provider (either selling or buying) in the underlying securities. While an ETF may be based on an index containing potentially thousands of securities, APs and ETF providers will transact in a much smaller, sample portfolio of the underlying index (which closely tracks the performance of the index). This process therefore requires the AP to execute purchases or sales in the underlying market, in portfolios of multiple bonds, very quickly (to avoid slippage), and often in simultaneously. This activity is largely electronified and facilitated by automated trading systems.

While not all investors have mandates, or preferences, to use ETFs, either as an investment instrument of a means of hedging beta risk, the redemption and creation process does create additional flows in underlying bonds between Approved Participants (including PTFs) and the ETF provider, which could be viewed as supporting bond market liquidity.

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.

Specifically, in the OEFs space, we do not consider that there are any excessive leverage concerns, and this is recognised at both global (IOSCO) and EU levels.

At the global level, in its 2023 Investment Fund Statistics Report, IOSCO concluded that "OEFs do not have large aggregate exposures through derivatives positions, and consequently, are not leveraged by any meaningful impact". IOSCO has also most recently reviewed the liquidity risk management (LRM) toolkit via its Guidance on Anti-dilution LMTs (December 2023) and is now working with the FSB, via the FSEG, to identify financial stability risks, stemming from leverage in NBFI. The FSB is expected to consult on policy approaches to address systemic risk from NBFI leverage at the end of 2024[16].

At the EU level, UCITS funds have to comply with a leverage cap of 100% and a borrowing cap of 10%. AIFMs have to demonstrate that the leverage limits for each AIF they manage are reasonable and that they comply with those limits at all times. The total amount of leverage employed is reported to the supervisors (with enhanced reporting obligations for leverage exceeding 300%) and also disclosed to investors. For ELTIFs, borrowing is limited to 100% of NAV. Article 25 of the AIFMD grants the competent authorities the ability to impose leverage limits, or other AIF management restrictions, to contain any possible build up of systemic risk attributed to leverage. For instance, this is a power which has been successfully deployed by the Central bank of Ireland in relation to Irish domiciled real estate funds in November 2022, and more recently in April 2024 on GBP LDI funds in coordination with Luxembourg's CSSF.

ESMA also has liquidity stress testing guidelines which require managers to ensure they are prepared to meet redemptions and liquidity demands from margin calls. ESMA has recently assessed risks posed by leveraged AIFs in the EU[17] and has concluded that NCAs have the right tools to have an accurate view of risks in their jurisdiction.

In its response to Q4, ICMA discusses the use of leverage by hedge funds as a core component of their investment strategies. This leverage is acquired either through the use of derivatives or repo: both of which are subject to highly granular EU reporting regimes (EMIR and SFTR respectively). European regulators should now have sufficient data to surveil any concentration of leverage or market risk, as well as identifying any risks related to interconnectedness. If the reality is that the data being provided, particularly under SFTR, is too detailed and complex to support meaningful

16 Enhancing the Resilience of Non-Bank Financial Intermediation: Progress report (fsb.org)
17 ESMA60-1389274163-2572 TRV article - Assessing risks posed by leveraged AIFs in the EU (europa.eu)

market oversight, then this should be a consideration in the upcoming SFTR review (perhaps also noting the FSB's 2018 guidelines which recommended SFT position reporting, rather than transaction reporting).

As well as utilising reporting data to support better market surveillance, there are other, more targeted regulatory tools available to tackle leverage. As highlighted in the response to Q4, constraints on banks' balance sheets as a consequence of banking prudential regulatory requirements, already put an indirect limit on the leverage available to hedge funds.

And while ICMA and its members, including CCPs, would not support the imposition of a mandatory clearing obligation for SFTs, more could be done to remove disincentives for increasing non-bank access to central clearing.

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

In the case of regulated entities, and activities that are monitored, systemic risks and vulnerabilities related to crypto assets are unlikely to emerge if they are subject to appropriate regulation, authorisation, supervision and risk controls through the scope of the entity-level, or product- level, regulations (e.g. current strict limitation of eligible assets for UCITS, and specific activity programmes for AIFs).

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.

Given the critical role NBFIs play as liquidity providers funding the real economy, it is important that macroprudential policies are designed without imposing undue burdens or stifling innovation as that could impact their ability in providing this role.

Instead of considering additional macroprudential tools, priority should be given to the regulation of the currently less monitored types of NBFIs and to complement supervision under the current requirements: supervision by banking supervisors on the adequate assessment of counterparty risks by banks, and supervision of markets by securities regulators through their mission of market surveillance.

In addition, supervisory coordination and collaboration should be encouraged as an effective mechanism, in particular to assess the less monitored NBFI's cross-border structures, rather than just assessing individual local entities. The recent AIFM and UCITS Directives enhanced the cooperation obligation among supervisors.

When comparing the funding structures of non-financial corporations, EU bonds have represented less than 15% since 1999 of total debt. The primary source of funding is loans. Whilst in the US, bonds represent more than three-quarters[18,19] This can be attributed to the structural dynamics, where in the US, small bonds issuance is a common practice to source funding, in the EU these small deals are less desired both by issuer and by banks due to regulatory burdens[20]. Easing the burden on bond issuance in the EU, might better facilitate funding opportunities for smaller companies, enabling NBFI's with an easier way of providing such funding.

Private Credit

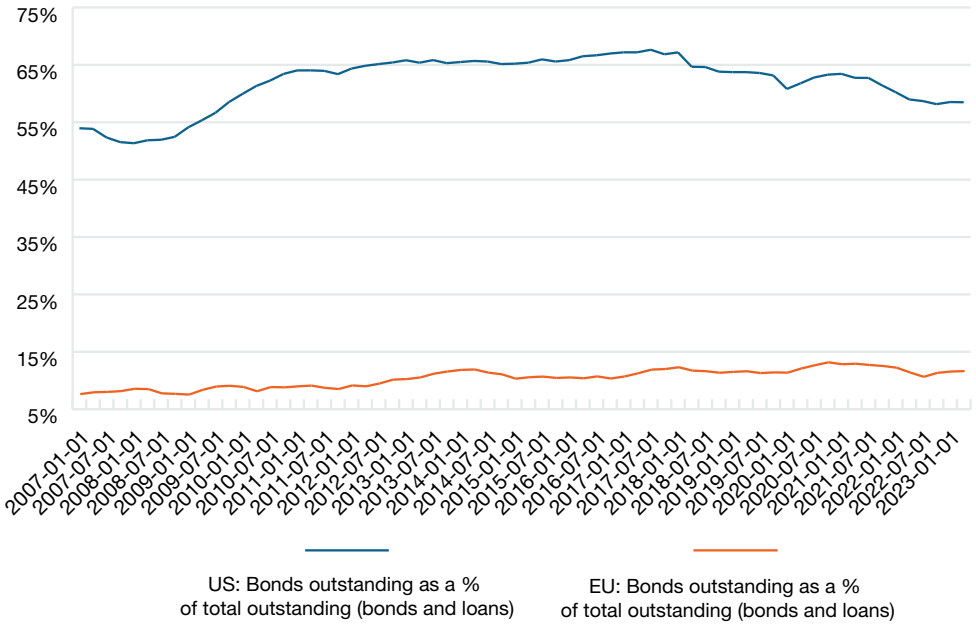
However, a more direct role for non-banks is through the provision of private lending. In recent years, there has been a sizeable growth in the private credit market, mainly in the US (growing from $1tn in 2020 to $1.5tn at the start of 2024). Much of this was the result of worsening conditions in the public credit markets post 2020, with firms finding it more difficult to access the high yield (HY) or broadly syndicated loan (BSL) markets. However, interest in the asset class has remained since the revival of the HY and BSL markets, both for borrowers and lenders. For borrowers there is the appeal

18 https://www.icmagroup.org/assets/documents/Regulatory/CMU/ICMA-Report-Bond-markets-to-meet-EU-investment-challenges-March-2024-210324.pdf
19 https://www.iwkoeln.de/fileadmin/publikationen/2016/277619/IW-Report_2016-11_SME-Financing-in-the-EU.pdf
20 https://www.ft.com/content/4a78f55f-3bc1-454b-9ce2-fed99b130c44#myft:my-news:page

of less onerous covenants and easier market access, while the spread between public and private debt has narrowed significantly. For investors it still offers attractive returns, as well as greater flexibility, such as in the event of defaults. Accordingly, the investor base has widened from traditional private equity funds to include insurers, pension funds, as well as retail investors. Deal sizes have become bigger (often as part of hybrid private equity deals), non-performance rates are currently low, leverage is limited (at around x2), and there is a deep enough pool of ready capital to absorb any market shocks.

Given the shifting shape of the economy, and the requirement for more SME-focused funding, private credit, along with private equity, is likely to play an ever-increasing role in the capital market ecosystem. Transparency in the private credit market continues to improve and the development of this important market should be preserved and any regulatory focus should be proportionate.

Figure 1: Financing structure in EU and US for non-financial corporations



Source: ICMA calculated using: BIS Data Portal, Summary of debt securities outstanding,
https://data.bis.org/topics/DSS/tables-and-dashboards/BIS,SEC_C1,1.0

ECB Data Portal, Loans vis-à-vis euro area Non-MFIs,
https://data.ecb.europa.eu/data/datasets/BSI/BSI.M.LU.N.A.A20.A.1.U2.2200.Z01.E

Board of Governors of the Federal Reserve System (US), Financial Accounts of the United States - Z.1,
https://www.federalreserve.gov/releases/z1/

2. Overview of existing macroprudential tools and supervisory architecture in EU Legislation

1. Money Market Funds (MMFs)

Supervisory powers

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

The existing EU MMFR already imposes rigorous rules on management between assets and liabilities of the fund through compliance of liquidity ratios (daily and weekly), adapted to the various types of MMFs (CNAV, LVNAV, VNAV). The existing liquidity ratios have proven their resilience during the COVID crisis as no major failures were observed despite challenging conditions. Delinking, which is widely supported by the industry and policy makers, would further increase the resilience of those MMFs which are subject to the link between liquidity levels and LMTs.

It would be highly counterproductive to increase liquidity buffers in times of stress as it would create procyclicality risks (where funds would be forced to sell out of assets during stressed conditions causing a spiralling, fire-sale situation). In times of stress, it is vital that MMFs are able to access their liquidity and avoid the risk of any second order effects.

Moreover, there are a number of cons in giving competent authorities powers to increase liquidity buffers on a collective basis:

- NCA intervention risks being negatively interpreted by unit and shareholders who may then be incentivised to redeem their units/shares which could create a first-mover advantage.
- Increasing cash buffers may complicate the funds liquidity risk management.
- Collective increases may be perceived as poor MMF performance and push investors to use other products to hold their cash in, which are less regulated than MMFs.

Increases on an individual level might only be feasible if this intervention can be done on a confidential basis and avoid triggering any negative market reactions and redemptions.

The focus should be on the use of LMTs to mitigate any potential risks rather than supervisory intervention via increasing liquidity buffer requirements. LMTs are also able to address the risk of first mover advantage more effectively than increasing liquidity buffers by reducing incentive to redeem early and ensuring fair treatment of investors. The upcoming AIFMD and UCITS revisions will also require MMFs to select at least one LMT by 2026.

Moreover, to make liquidity more usable, it is important to facilitate the delinking of regulatory thresholds from the activation of LMTs and for MMF managers to feel comfortable to use their liquidity buffers when necessary.

Finally, having better knowledge of end-investors is also a relevant tool to better anticipate end-investor behaviour and avoid any substantial outflows.

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 highlighted in Q8, we are not supportive of giving NCAs power to increase liquidity buffer requirements in times of stress given the procyclicality risks.

MMF supervision currently occurs at the national level rather than at EU level. Asset managers submit reports and stress test results to their local regulators, who handle any market-related issues.

This information does not seem to be shared between the NCAs as well as with ESMA. **Before considering any further coordination between ESMA and the ESRB, the priority should be to enhance coordination between the local authorities and ESMA.** This would facilitate a more comprehensive view of MMF risks and activities across the EU and would help promote a level playing field across Europe.

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?

The current reporting obligations for regulated MMFs under MMFR work, and we do not see the need for any additional reporting requirements. There is a risk of ending up with unexpected outcomes in terms of new obligations for EU MMFs which could harm their global competitiveness. Furthermore, MMFR reporting is tailored to address the specificities of MMFs whereas the new UCITS supervisory reporting obligations and improvements to AIFMD reporting, aim to capture comparable data for a highly heterogenous group of funds. The different reporting frameworks for MMFs and UCITS and AIFMD fulfil different needs and purposes and are not so simple to align.

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?

Stress testing of MMFs including liquidity provisioning is already thorough and updated by ESMA on an annual basis. Stress testing exercises today are mainly conducted at a local level. We agree it should be aggregated at EU level and that corresponding results should be shared with the asset management community at a minimum.

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?

ESMA stress testing Guidelines already apply across all EU MMFs. The Guidelines are specific to MMFs, are robust, detailed and updated by ESMA on an annual basis in accordance with the requirements of MMFR. There would be significant costs associated with developing and maintaining an EU wide stress testing framework and would impose an increased operational burden on MMFs to comply with additional requirements. Moreover, stress tests are only a captured moment in time and would not be very informative given the fast-changing portfolios of MMFs given their short-term nature.

Ultimately, additional and/or system wide stress testing would not result in a meaningful addition to resiliency and a cost benefit analysis should be done before making it more strenuous.

Reverse distribution mechanism

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

The MMF industry was not supportive of the ban in 2019 given that its use was very practical and efficient in accommodating negative interest rates.

Since the ban, MMF managers and investors have adjusted their processes to the use of "accumulating" share prices (which de-cumulate as value is eroded by negative interest rates). However, from a policy perspective there is no reason to ban its use and its reintroduction would allow the flexibility for a wider user base in a scenario where there was a return to negative interest rates.

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

No comment.

Liquidity and short-term instruments

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

We do not believe that this is necessary as this type of requirement would not increase the current liquidity of money market instruments. Existing ratios are sufficiently efficient and do not need to be improved with this type of request.

2. Other Open-Ended Funds (OEFs)

Link between liquidity mismatch and liquidity risks

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

We consider that NCAs already have access to all the necessary tools to monitor the liquidity profile of OEFs to detect unmitigated liquidity mismatches, especially as both the AIFMD and UCITS Directives have been revised and finalised in March this year[21].

The revised AIFMD and UCITS frameworks will introduce additional reporting requirements, make the full LMT toolkit available across all jurisdictions and mandate funds to select at least 2 LMTs from the list (Annex V of AIFMD and Annex IIA of UCITS Directive). This will support in further enhancing existing liquidity risk management practices and harmonise practices across the EU. ESMA is working on the detail of the characteristics and the selection and calibration of these LMTs via level 2 and level 3 measures which are scheduled to be adopted in April 2025.

The ECB and national central banks already receive very extensive data on the detailed assets and liabilities of each individual investment fund, particularly AIFs and UCITS, in the form of fund inventories. In order to equip NCAs with the ability to better monitor the liquidity profiles of OEFs, ESMA and the NCAs should be granted access to the data the ECB and national fund managers already receive on a monthly and quarterly basis. Moreover, a new supervisory reporting regime will be introduced via the revised UCITS Directive and ESMA is due to publish a review of AIFMD supervisory reporting. It would be prudent to wait for the forthcoming implementation of the revised AIFM and UCITS Directives, and the outcome of the ESMA review, before considering any further additional reporting requirements.

Question 16. [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 applicable

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

Asset managers use a broad range of data, and practices, to monitor the liquidity risk of their investment funds:

21 Directive (EU) 2024/927 of the European Parliament and of the Council of 13 March 2024 amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, the provision of depositary and custody services and loan origination by alternative investment funds (europa.eu)

- "Macro data" relating to financial markets as a whole (e.g. interest rates, main financial indices, level of margin calls)
- "Micro data" relating to the investment funds themselves and the volumes of inflows/outflows, underlying assets and their pricing, redemption scenarios (which includes historical redemptions data, investor concentration types, likely margin call estimates etc), and all other considerations which may cause activation of LMTs.
- Fund boards and specialist committees in charge of funds' liquidity risk management meet on a regular basis, and more frequently as necessary in cases of market stress, in order to provide the necessary oversight and governance concerning the funds' liquidity risk management practices.

It is also important to note that regarding regulated OEFs, NCAs review and approve key legal documents, such as the prospectus and the key information document, pre-launch of a fund which includes the liquidity risk and liquidity risk management policy. It is also common practice for the fund managers to enter into discussions with their NCAs during this pre-authorisation phase, to discuss the proposed fund structure, liquidity structure and how they would respond in times of market stress. The final structure and relevant liquidity risk management processes are thus agreed between the fund managers and their NCAs prior to launching a fund[22] and once the funds are launched, securities regulators are responsible (along with fund managers) to monitor in practice the compliance with such legal commitments.

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 applicable

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

The EU UCITS and AIFM Directive frameworks already ensure that NCAs receive information related to relevant funds.

Further, we would advise against any specific measures targeting "cohorts of funds". Funds even within the same "category", will experience market events differently and the decision to activate any LMT will be based on fund-flow data which differs fund to fund and as such cannot be grouped as "cohort of funds". For this reason, it is legitimate for LMTs to be deployed differently across different funds within the same asset manager and across different asset managers in the industry.

It is ultimately the fund manager who is best placed to make the decision on LMT activation given they are best informed on the latest fund flow data. Attempting to calibrate LMTs and manage risk at an aggregate level across a "cohort of funds" risks forcing funds to act in the same way, and at the same time, which could result in an exacerbation, rather than a mitigation, of procyclical market effects.

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

As mentioned previously, proper use of LMTs is particularly effective when fully deployed and the currently required provisions of the UCITS and AIFM Directives ensure that measurement and monitoring

Additionally, close dialogue between the NCAs and the asset managers remains essential in this type of situation as each crisis is different from the previous one. Only activating some tools in an automative way without minimum flexibility and discretion for the industry could have unintended consequences.

22 AMIC-EFAMA-Managing-fund-liquidity-risk-in-Europe-2020-220120.pdf (icmagroup.org)

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?

Asset managers are already very well equipped with tools to address liquidity mismatches and this topic has also been very recently addressed at both EU and global level. In the EU, given the recent review and harmonisation of the AIFM and UCITS Directives, the full liquidity management toolkit, including anti-dilution tools, will be available across all EU member states with the new rules taking effect from 16 April 2026.

At global level, both FSB and IOSCO have undertaken significant work to address liquidity mismatches in OEFs. Their review has resulted in FSB policy recommendations on addressing liquidity mismatches and IOSCO guidance on anti-dilution LMTs[23].

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

Calibrating worst-case and stress-case scenarios may be challenging as each crisis is different and thus it is difficult to anticipate which assumptions should be taken into consideration and in which proportion.

Fund distributors also hold a lot of critical data related to their end clients. Facilitating data sharing from fund distributors to fund managers, in anonymised format and on a free-cost basis regarding the clients, would facilitate the asset managers' assessments in anticipating any risks related to clients' redemptions.

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 applicable

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 applicable

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 applicable

3. Other NBFIs and markets

Other NBFIs

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

As we highlight in response to Question 1, we consider there are two specific ways to improve preparedness in meeting margin calls.

The first one would be to allow high quality liquid assets (particularly MMFs, government bonds, and other high-quality securities) to be used as collateral, alongside cash, in meeting variation margin calls on centrally cleared markets, to help ease any liquidity stress which may be caused by a high volume of margin calls.

23 FSB and IOSCO publish policies to address vulnerabilities from liquidity mismatch in open-ended funds - Financial Stability Board

Otherwise, variation margin calls on centrally cleared and bilateral markets, if required by CCPs only in cash, generate a procyclical effect increasing market turmoil – as it was seen in March 2020. Alternatively, firms may rely on the repo market as a vehicle for transforming securities into short-term cash in order to meet margin requirements. However, in times of heightened volatility or stress, banks are often forced to shrink their balance sheets, reducing their intermediation capacity for what is a capital intensive/low return activity: meaning that the repo market cannot necessarily be relied upon as a source of ready liquidity[24]. This is also the case around regulatory reporting dates, such as calendar year-end[25].

In order to address the above-mentioned balance sheet constraints banks face in times of stress, we would advise as the second important consideration to be for regulatory barriers to be removed which impede the uptake of CCP sponsored models for repo. CCPs sponsored models have been specifically developed to address banks' intermediation issues and would grant NBFIs direct access to clearing with the support of a bank (agent). Through sponsored models, banks can free some of their balance sheet through netting and reduce their Counterparty Credit Risk impact though CCP Risk Weight. This additional intermediation capacity would guarantee NBFIs access to liquidity, even under times of stress, at a reliable price.

Therefore, as we also highlighted in Q1, a key regulatory decision to reduce the risk of amplifying market turmoil would be:

1) to ensure that high quality liquid assets, particularly MMFs, government bonds and other high quality securities bonds, are recognised by all EU CCPs as eligible collateral for answering variation margin calls on centrally cleared and bilateral markets;
2) Remove regulatory barriers impeding the uptake of CCP sponsored models.

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.

An important way to effectively monitor liquidity and margin preparedness for NBFIs is to make use of the data that is collected through market surveillance and ensure adequate counterparty risk assessments by authorities.

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.

While it is important to reflect upon the events of autumn 2022 in the UK, it is important to not draw too many parallels to EU pension funds. The case in the UK was an isolated situation where the size of the UK DB pension fund sector vastly dominated certain parts of the gilts market.

We support the broad approach adopted by the Central Bank of Ireland in its response to GBP denominated LDI funds domiciled in Ireland. In particular, it is sensible to have an approach that focuses on identifying major risks, stress tests the liquidity of the portfolio for potential collateral calls against basis points moves for different market variables, and report the results to the regulator on a regular (e.g. monthly) basis.

We support any European response for EU pension funds to be coordinated across different NCAs so that market participants do not need to create multiple stress tests or reporting. The approach should be sufficiently flexible so that pension funds in different EU countries can run the stress test that is relevant for their market structure and portfolio.

24 The-European-repo-market-and-the-COVID-19-crisis-April-2020-270420v2.pdf (icmagroup.org)
25 ICMA ERCC year end report 2016 AndyHill 020317.pdf (icmagroup.org)

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?

Given EIOPA already undertakes regular stress testing of pension funds, we do not consider there to be any added benefit in additional EU – wide liquidity stress tests for pension funds as redemption risk is already limited for this type of fund. In general, the more relevant considerations for pension funds relate to solvency, coverage ratios and ability to meet liabilities. These data points are already considered for EIOPA's stress tests, so it is not clear what additional benefit new or expanded stress testing of pension funds would bring.

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?

Increasing transparency:

While some areas of the CP market exhibit good levels of transparency, reliable and consistent data is not always available, and its quality remains uneven in certain domestic markets. Where data does exist, it often varies in terms of reference points and consistency, leaving parts of the market uncovered. There may also be instances of double-counting, missing data or transactions being marked as confidential. The absence of a common, reliable and publicly available (at no cost) aggregator across these various markets creates challenges in comparing CP data effectively.

A fully consolidated, publicly available source of information that provides a holistic view of the market could help build greater confidence among potential issuers, investors, and intermediaries. Such transparency could support the development of generic yield curves, enabling new issuers to better assess their potential issuance levels. Increasing and improving the level of publicly available information, in turn, could lead to increased secondary market activity and improved liquidity. By ensuring that all market participants have access to the same information, this could reduce information asymmetry and encourage standardised practices and documentation.

However, it is crucial to consider the implications of requiring transparency around pricing levels. It is also important to differentiate between instruments such as bonds, where pricing is transparent, and CP, where it is not. Bonds are issued less frequently than CP because they are generally used to fund strategic purposes. This infrequent issuance pattern leads to greater pricing stability. In contrast, CP is often used as a tool for liability management and is issued more frequently. Consequently, fluctuations in pricing levels may reflect issuers' needs but can also be indicative of other influences.

While transparency around pricing levels could enhance the CP valuation process, disclosing such information might lead to misinterpretation of an issuer's financial health, business operations, or funding strategies. This could potentially amplify funding sensitivities, particularly during times of market stress. Additionally, because CP is often highly bespoke, issuers may resist being influenced by publicly disclosed past pricing levels, especially if those levels apply to transactions of varying sizes. A requirement to disclose pricing levels could inadvertently drive issuers toward other markets, such as private placements, where information is less openly shared, potentially reducing liquidity in the CP market.

Finally, while improved transparency is a valuable ambition, on its own, it is unlikely to revolutionise primary issuance or necessarily stimulate more secondary market activity.

Standardisation:

Currently, the range of different CP markets (including ECP, NEU CP and active domestic markets in Germany, Spain, Belgium and Italy) is considered inefficient and introduces unnecessary complexity. A single, standardised form of CP could streamline practices across markets by introducing more uniform terms and structures. This could give CP a more professional, accessible veneer, which could increase investor confidence (noting that some larger investors are agnostic about what form of CP they buy), making it easier for them to compare, understand, price, and trade CP, while

also broadening the market's appeal and accessibility to a wider range of issuers. Reducing barriers to entry by way of standardisation could expand and deepen market participation, potentially encouraging more active trading and greater liquidity in the secondary market. Standardisation could also establish a baseline structure that would enable the market to more easily adopt new products or innovations.

Simplifying the issuance, trading and settlement processes, along with consistent documentation and disclosure requirements (without limiting the inherent flexibility offered by a CP programme), could accelerate issuance, reduce costs, enhance transparency and lower the demand for legal, compliance, and administrative work.

In practical respects, standardisation would be helpful in the following areas:

- note denominations: so that dealers no longer have to check denomination requirements in each programme, particularly for irregular-sized trades,
- forms of notes: currently, options include physical, global permanent, global temporary, new global note (NGN) global permanent and NGN global temporary,
- for floating rate CP: standardised terms for interest calculations (for example, lookback) would be easier to manage and would lead to fewer discrepancies,
- ISIN rules: for instance, XS ISINs take account of issue dates, whereas BE, FR and DE ISINs do not, and
- centralising and speeding up ISIN generation for new issues (which can take anything from a few minutes to 2 days to generate).

Digitalisation may also have a role to play, for instance with instantaneous ISIN code creation and accessibility of instrument characteristics through data providers.

On the other hand, it is important to note that the development of domestic markets has grown around specific needs. A single standardised market be exclusive and might pose challenges for smaller, domestic markets and unrated issuers and local investors who are accustomed to their local investor/issuer bases, respectively, and are familiar with the local regime while also benefitting from the ability to access the ECP market.

Finally, while improved standardisation is a valuable ambition, on its own, it is unlikely to necessarily stimulate more secondary market activity.

Design of the framework, or label:

When designing a **framework** for standardisation, several important questions arise: Could CP under a particular framework co-exist with conventional CP, and if so, would this lead to arbitrage opportunities or a bifurcation of liquidity? Additionally, what would serve as the 'benchmark' and legal system for standardisation? A label for CP, based on a mechanism similar to STEP, could be achievable, particularly if the different markets could co-exist, but with the additional overlay of a stamp or kitemark of adherence to a particular agreed set of standards.

There could be many advantages to a framework or label, which should be considered at the design stage. This could include:

- more regular updates of documentation on a consistent frequency (allowing disclosure to also be updated),
- a centralised source for information memoranda and issuer information,
- a centralised source for programme activity information[26], in particular outstanding amounts under programmes (as many investors can only buy a proportion of current outstanding amounts),
- basing the design around central bank eligibility / ECB repo eligibility, which might encourage issuers to set up label-compliant programmes, and encourage investors to buy label-compliant CP,

26 Such as is reported in the US by the Fed: The Fed - Commercial Paper Rates and Outstanding Summary

- increased and holistic transparency of the market, mindful of the considerations set out above, and
- flexibility to accommodate the many variables that define the bespoke nature of CP, such as tenors, amounts, currencies, the specific requirements of issuers and investors and the shape of the yield curve.

Ideally, best practices from existing markets could be leveraged to create a clear regulatory framework that ensures transparency and efficient post-trade processes, and taking into account the above design elements, where voluntary solutions already exist, the market might be incentivised to use them (or elements of them) thereby obviating the need to develop new ones. This would require careful consideration of the impact on existing markets, as well as costs to market participants. Documentation would need to be standardised and disclosure requirements aligned to avoid mismatches (noting again that this should not limit the inherent flexibility offered by a CP programme); given there is generally no obligation for an annual update of a CP prospectus, this would give rise to significant expenses for issuers for whom a CP Programme is relatively cheap to maintain, and for whom the benefit of a single standardised market may be marginal.

Domestic CP markets, which operate under different regulatory regimes, would also need to be aligned; an effort that would require both willingness and commitment from local markets to truly integrate a standard.

Question 30. Should the scope of eligible instruments to such framework/label be aligned with Article 3 of Directive 2007/16/EC60 [UCITS][27]? If not, please suggest what criteria would you consider for identification of eligible instruments.

No comment.

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?

CP allows issuers to raise working capital and secure short-term funding across various currencies. It offers flexible maturities and a relatively quick and straightforward issuance process, with lighter documentation and disclosure requirements compared to public bonds. Due to its inherently lower risk relative to bonds, CP often carries lower costs, both in terms of relative spreads and associated fees, such as bank charges.

Increasing the range of issuer participation in the CP market (either directly or by way of sales of assets to an asset-backed CP vehicle (ABCP)) can support the operations and growth of smaller companies, contributing to financial stability. A more diverse issuer base could also enhance market liquidity, as well as deepen and strengthen the overall market. CP generally attracts strong and consistent demand, enabling issuers to diversify their investor base, which can spread risk across a wider pool of participants, leading to a more resilient financial system. Additionally, CP allows issuers to diversify their funding sources, beyond reliance on bank loans. This, in turn, distributes credit risk more broadly across the financial system, potentially bolstering stability.

However, while CP issuers are typically higher-rated, smaller issuers may not be (noting that their credit may be enhanced by way of aggregation of high-quality assets in an ABCP) and are often more vulnerable to economic downturns. This could lead to a rise in defaults on CP repayments, posing risks to market stability. If smaller issuers gain a significant presence in the CP market, their collective failures could introduce systemic risk, particularly if they are highly interconnected with other financial institutions and products. A wave of defaults could undermine investor confidence in CP, triggering a sudden withdrawal of funds from MMFs and exacerbating liquidity challenges. There could also be cost implications for issuers if they were required to seek a rating to access the CP market.

Further, issuer diversification might require a mindset change among investors who may view smaller issuers as too risky due to their often-conservative investment policies (money markets being a tool to preserve principal as much as to generate a return) and for whom smaller transactions might lead to increased costs of credit.

27 Such as is reported in the US by the Fed: The Fed - Commercial Paper Rates and Outstanding Summary

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

The ECP market is not simply European; it is offshore and as such, is a global market with participants spanning the globe, issuing in multiple currencies. The UK market should not be treated as a separate subset of the ECP market, particularly given the difficulties in defining applicable parameters: currency, governing law, location of issuer, location of dealers, location of investor/ fund, etc.

The ECP market is well-established, with significant depth and liquidity. It attracts a broad range of global investors, providing issuers with access to a large and diversified investor base and strong, consistent demand. Historically, the ECP market has led the development of CP markets outside of the U.S. and continues to dominate, despite shifts in the political and economic landscape, including Brexit.

Many issuers prefer issuing in an international market like ECP rather than domestic ones as they offer access to a broader investor base and greater flexibility in funding. Issuers can also tap into demand from investors seeking euro exposure, even if those investors are based outside the EU. Additionally, the English law legal framework is widely recognised and understood internationally, offering predictable outcomes, which helps reduce legal risks and associated costs compared to less familiar domestic systems.

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

Before addressing this question, it is important to understand that CP is a very different instrument to bonds with respect to trading.

Bonds are issued in much larger sizes, less frequently and for strategic purposes, and tend to trade more freely and frequently in the secondary market[28], CP is a source of working capital for issuers, rather than a strategic funding tool. For investors, it is a safe alternative to deposits. Added to this, due to the short-term nature of CP and the conservative, non-leveraged nature of the investor base, most issuers and investors adopt a buy-to-hold strategy, and this is not likely to change. There is therefore little CP trading in secondary markets; this may be more a reflection of the fact that investors do not want to sell, rather than an inability to sell. That is not to say there is no secondary trading at all, though while liquidity in the CP market is generally adequate given the sparse trading pattern, it tends to be relatively thin. Consequently, liquidity is primarily provided by dealer banks repurchasing previously placed paper, leading to a heavy reliance on dealers' balance sheet capacity[29] in a climate where dealer banks face constraints on their capital resources and are subject to regulatory requirements, such as the Liquidity Coverage Ratio and risk limits, that restrict their ability to make markets; all of which is exacerbated in times of crisis. In the absence of different capital rules for short term assets, this disadvantages CP disproportionally. CP is a low-margin, capital-intensive business for the dealer banks, and providing secondary liquidity is often a relationship-driven service, all of which limits the appeal of secondary trading.

But while secondary market liquidity remains a challenge, it does not necessarily reflect ECP's underlying resilience. For example, during the March 2020 crisis, a combination of factors - investors selling out of ECP in favour of cash, issuers drawing on their revolving credit facilities, and the timing coinciding with quarter-end reporting - raised concerns about CP's stability. However, this was primarily seen as a result of capital intensity and constraints on bank balance sheets. The March 2020 crisis extended beyond ECP, with central bank interventions aimed at stabilising the broader financial system, not just ECP. In more recent crises, the ECP market has continued to function smoothly.

That said, the following incremental steps could help improve secondary market liquidity in the CP market, presented for consideration in terms of priority:

28 ICMA-SMPC-report-European-Secondary-Bond-Market-Data-H2-2023-March-2024-190324.pdf (icmagroup.org)
29 CP and CDs markets: a primer (bis.org)

- **Capital and liquidity relief under Basel rules:** Providing relief to dealers, particularly during times of market stress, could encourage them to hold more inventory and bid back additional paper, thereby enhancing an existing source of secondary market liquidity. Recognising highly rated CP as high-quality liquid assets (HQLA) in capital ratios would be a positive move in this direction.
- **Developing a repo market for CP:** A dedicated repo market would give dealers greater flexibility in funding their inventory and provide investors with an option to raise liquidity against their CP holdings without having to liquidate them, avoiding panic selling.
- **Increased transparency and accessible data:** Better transparency and the availability of data could boost primary issuance volumes, and as a consequence, secondary market activity. However, as noted in the response to question 30, this must be balanced with concerns about transparency around pricing levels.
- **A more diverse investor base:** Expanding the range of investors, particularly those with different investment strategies or motivations for holding CP, could strengthen secondary market liquidity.
- **Trading platforms:** These platforms could help consolidate multiple sources of liquidity and improve price discovery. However, while they can enhance market functioning, they are not necessarily a substitute for liquidity, especially during times of volatility or market stress. A well-functioning CP market still relies on dealer expertise, intermediation, and the capacity to take positions.
- **A central bank purchase programme:** Central bank provision of a "bid of last resort" for CP would allow dealers to continue supporting the market when they are otherwise constrained.
- **Broader central bank eligibility for CP in money market operations:** Expanding central bank eligibility would improve the repo-ability of CP, offering an additional funding option for dealers, especially for financial CP/CDs and asset-backed CP.

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?

Yes – and we consider it not necessary to change the maturity threshold. 397 days has long delineated money markets from bond markets. It is also important to note that the MMFR rightly provides a broader scope when defining assets eligible for EU-domiciled MMFs, allowing for "short-term assets" with maturities of up to two years (MMFR, Article 2(1)).

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.

It is generally considered that there are a large number of investors involved in the CP market: funds, central banks, sovereign wealth funds, insurance companies and pension funds - some may be bigger than others, but none are considered to have a monopoly. However, any measures which drive concentration within MMFs themselves (for instance, aligning the rules applied to LVNAV and VNAV MMFs) could increase systemic risk in certain scenarios.

The following points therefore apply to high concentrations of a few investors in any market:

- the risk of interconnectedness and contagion, where difficulties faced by one group of investors could quickly spread across the market,
- if a concentrated group of investors were to suddenly withdraw, liquidity shortages would likely follow,
- when a high concentration of investors follows similar investment strategies, they could be equally impacted by the same economic or financial shocks,
- it could reduce competition within any market, making it harder for new entrants to gain access and could lead to more favourable terms for dominant participants, which could also potentially discourage innovation if it affects the status quo unfavourably, and
- it could also encourage a "herd mentality" among investors, leading to uniform behaviours that increase costs for issuers.

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

Fundamentally and for the reasons set out in the response to question 33, there is little CP trading in secondary markets, but that is not to say there is none. But there is, and will likely remain, heavy reliance on dealer banks buying back paper and so maintaining a dealer-to-client (D2C) secondary market model is crucial.

However, reducing this reliance by attracting a more diverse investor base through a client-to-client (C2C) model, co-existing alongside the D2C model, is a worthwhile goal which could help to attract and improve secondary market liquidity.

Members of the ICMA Corporate Issuer Forum who are active in the CP market concluded that corporates might be encouraged to participate in CP on a C2C model under certain conditions: if liquidity allowed divestment at any time, if direct investments offered better yields than MMFs, and if there were greater visibility on pricing levels (while acknowledging the concerns about transparency around pricing levels mentioned in the response to question 30).

Additionally, as noted in the response to question 30, (i) a fully consolidated, publicly available source of holistic market information could help build greater confidence among potential investors, and (ii) standardisation of CP could help to increase investor confidence by making it easier to compare, understand, price, and trade CP. Finally, electronic trading platforms that offer continuous bid/ask spreads, market data and lower transaction costs could attract a wider range of investors (but see further response to question 37).

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

We begin by expressing our fundamental concern with the underlying premise of introducing an 'obligation' to trade these instruments on designated trading venues. Such a mandate would constitute a significant shift for a long-established and well-functioning market that thrives on the flexibility and efficiencies of over-the-counter (OTC) trading.

Further, it is unclear what the term "trading venues" means, as the term can refer to different systems, depending on the trading protocols. For instance, a Central Limit Order Book (CLOB) may work well for very liquid products, while a Request For Quote (RFQ) model might be more suitable for less liquid products like bonds and CP.

As noted in the response to question 15, admission to trading on whichever type of venue, or evidence of trading activity, is not considered necessary as it would not increase the current liquidity of money market instruments, including CP.

There are a number of other potential significant disadvantages to introducing an obligation to trade on trading venues.

The short-term funding market benefits from a diverse range of investors (including categories of MMFs) and issuers. Imposing specific trading requirements on market participants could undermine this diversity, potentially discouraging participation and affecting liquidity.

As highlighted in responses to questions 33 and 36, the market continues to rely heavily on dealer banks repurchasing paper, making the D2C secondary market model essential. So while trading venues might support market functioning, they are not a substitute for dealer intelligence, and an obligation to trade on venues might lead to dealer disintermediation or reduced margins, which could prompt dealers to exit the market, thereby decreasing overall liquidity. And if multiple trading venues were used, liquidity could become even more fragmented, reducing the overall market depth.

In a relatively illiquid market like CP, the ability to negotiate and transact bilaterally without alerting the wider market is important. For larger issuers accustomed to OTC trading, an obligation to trade on venues would limit this flexibility.

Due to the lack of standardisation in the market (e.g. in terms of issue dates, tenors and denominations) and the fact that

pricing is negotiated each time, quoting for each trade could be challenging, and as CP is typically refinanced, quoting on a continual basis for each rollover adds complexity. Additionally, if pricing were based on a standard curve, the impact on existing, off-the-run issuances is uncertain. Given these factors, along with pricing complexities, calibrating spreads may also prove difficult, potentially requiring wider spreads to compensate for the risk of execution.

There are also cost considerations. The initial setup, as well as ongoing operational, security, and IT testing costs, could be prohibitive - particularly if regulatory or compliance adaptations are required. Dealers may also require resource for inventory monitoring and trade control. These combined costs could lead to lower participation from various market participants and could steer issuers to other types of funding, such as private placements, or bank borrowing, which would be a further pressure on banks' balance sheets.

Finally, the CP market would have to move wholesale to trading on trading venues. One reason why this has not happened so far is that there is currently no perceived first mover advantage in doing so.

An obligation to trade on trading venues *might* lead to a more regulated and transparent environment, simplify the assessment of counterparty risk and facilitate position matching through concentrated trading on fewer platforms. However, these perceived benefits must be carefully weighed against the significant implications such a shift could entail, as set out above.

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)?

The response to this question assumes that the whole CP market has moved to trading venues, and that liquidity remains manly concentrated on one or a small number of them.

In a *truly* systemic event, the only way to improve liquidity is to have a central bank purchase programme as a bid of last resort. For events that are not necessarily truly systemic, regulated venues could promote orderly trading in a controlled environment, which would contribute to market stability. If these venues provided real-time data on prices (mindful of the concerns regarding pricing levels mentioned in the response to question 30) and trading volumes, they could help market participants assess the value of their CP during periods of stress. This access to information could facilitate trading and potentially reduce the likelihood of panic selling or sudden withdrawals of liquidity from the market, although all participants being on the same platform might increase volatility.

Regulated venues could serve as a valuable platform for MMFs to efficiently divest their CP holdings. If a diverse range of participants with varying risk appetites were active on these regulated venues, it could help maintain liquidity even in stressful situations.

However, in stress situations it might be optimal to trade bilaterally OTC because sellers would be recognised as 'distressed' on platforms and would therefore be vulnerable to price pressures.

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 applicable

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 applicable

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?

ICMA is not commenting on the commodities markets questions as it's not within its area of expertise.

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?

Specifically to bond markets (sovereign in particular), ICMA recognises the role of some NBFIs such as hedge funds in the provision of liquidity, as already explored in answer to question 4. Unlike primary dealers[30] however, they have no commitment to provide a two-way quotation on a continuous basis. During periods of heightened volatility and low liquidity, they can halt trading, causing in turn even more liquidity risk. ICMA interviewed both buy-side and sell-side members in its Liquidity and resilience in the core European sovereign bond markets and participants observations are summarised as below:

[…] Of more significance, particularly to some interviewees, is the role of hedge funds, in particular relative value (RV) funds that utilise leverage to enter into short-term strategies to exploit potential price opportunities between different sovereign bonds and instruments. Participants also note a resurgence in hedge fund activity since the end of interest rate compression and with this an increase in volatility, both of which provide more opportunities for RV based trading. Views on the contribution of hedge funds to market liquidity and resilience are mixed. On the one hand they provide new and active flows, often contrary in direction to more passive, real money orders, that otherwise would probably not exist in the absence of bank "prop" desks. There is also the argument that they ensure price efficiency, by arbitraging-out any price anomalies that exist in the market. However, as some interviewees were keen to point out, unlike Primary Dealers, they have no commitment, nor incentive, to stay active when markets become too volatile or stressed. They are often the first to pull-out when the going gets tough, often adding to the volatility as they deleverage and unwind.

As explained in the response to Q1, there is an important interconnectedness between the repo market and bond markets more generally. To the extent that repo markets are unable to fulfil their role, or certain non-banks are unable to access the repo market, say to manage liquidity or to meet margin requirements, then this can have significant procyclical impacts on the bond market.

Furthermore, while bond and CP markets serve distinct roles - bond markets primarily support long-term strategic funding, while CP addresses short-term liquidity needs like working capital - these markets are interlinked. If liquidity were to dry up in the CP market, issuers would likely shift to private placements or traditional bank financing at possibly less favourable rates (due to increased supply and issuers being recognised as in need of a funding alternative). This could strain banks' balance sheets and potentially put additional pressure on bond markets, including banks' ability to underwrite new bonds, and would further reduce liquidity in the CP market.

30 Primary dealers are typically sell-side banks, appointed by sovereign issuers to issue debt and provide a bid-ask quotation on a continuous basis

3. Excessive Leverage

1. OEFs

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

Specifically, in the OEFs space, we do not consider that there are any excessive leverage concerns, and this is recognised at both global (IOSCO) and EU levels.

At the global level, in its 2023 Investment Fund Statistics Report, IOSCO concluded that **"OEFs do not have large aggregate exposures through derivatives positions, and consequently, are not leveraged by any meaningful impact"**. IOSCO has also most recently reviewed the LRM toolkit via its Guidance on Anti-dilution LMTs (December 2023) and is now working with the FSB, via the FSEG, to identify financial stability risks, stemming from leverage in NBFI. The FSB is expected to consult on policy approaches to address systemic risk from NBFI leverage at the end of 2024[31].

At the EU level, UCITS funds have a (synthetic) leverage cap of 100% (and a borrowing cap of 10%) and AIFMs have to demonstrate that the leverage limits for each AIF they manage are reasonable and that they comply with those limits at all times. The total amount of leverage employed is reported to the supervisors and also disclosed to investors. Further, if the leverage goes beyond 300%, AIFMs have to comply with enhanced related fund reporting to regulators. For ELTIFs, borrowing is limited to a maximum of 100% of NAV. Article 25 of the AIFMD grants the competent authorities the ability to impose leverage limits, or other AIF management restrictions, to contain any possible build-up of systemic risk attributed to leverage. This is a power which has been successfully deployed by the Central bank of Ireland in relation to Irish domiciled real estate funds in November 2022, and more recently in April 2024 on GBP LDI funds in coordination with Luxembourg's CSSF.

ESMA also has liquidity stress testing guidelines which require managers to ensure they are prepared to meet redemptions and liquidity demands from margin calls. ESMA has recently assessed risks posed by leveraged AIFs in the EU[32] and has concluded that NCAs have the right tools to have an accurate view of risks in their jurisdiction.

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

Any measurement of leverage for LDI should be based on yield-buffers rather than outright leverage. This is because leverage numbers can be distorted based on the duration/maturity of the LDI fund. For example, two LDI funds with two different maturities and the same yield buffer will show different leverage numbers. Therefore, the yield buffer is the more reliable to measure to look at.

That being said, the risk posed by EUR denominated LDI funds are different to those posed by GBP LDI funds and therefore we do not recommend that EU policymakers stipulate any yield-buffer limits for EUR denominated LDI funds. It must also be noted that where yield-buffer limits do exist for GBP LDI funds, there is flexibility built into this framework to ensure that these yield-buffer limits themselves do not cause a cliff-edge effect. The framework therefore envisages a number of measures including regulators having the ability to relax these in stressed conditions, if necessary.

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.

As highlighted in response to Q43, leverage in EU OEFs is sufficiently addressed through the existing UCITS, AIFMD and ELTIF frameworks and thus we do not consider there to be a risk of pockets of excessive leverage that could not be addressed with the existing toolkit.

31 Enhancing the Resilience of Non-Bank Financial Intermediation: Progress report (fsb.org)
32 ESMA60-1389274163-2572 TRV article - Assessing risks posed by leveraged AIFs in the EU (europa.eu)

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

In practice UCITS can only invest in other UCITS (or equivalent), therefore ruling out this issue. For AIFs, there is a disclosure requirement where AIFs invest a material amount in another fund.

2. Other NBFIs and markets

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

Due to a lack of data, we are not aware of specific NBFI sector entities with high leverage in the EU that could be a source of systemic risk. As highlighted in Q43, IOSCO Investment Funds Statistics Report reports both gross leverage and financial leverage for qualified hedge funds (QHFs), open-ended funds (OEFs) and closed-ended funds (CEFs) for 2023. Most importantly, IOSCO concludes that **"OEFs do not have large aggregate exposures through derivatives positions, and consequently, are not leveraged by any meaningful impact"**.

It is therefore helpful to reiterate, that the highly regulated NBFI entities do not pose any systemic leverage risks.

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

In order to deal with leverage of NBFIs that are not currently included in EU legislation, the focus should be on enhancing monitoring and supervision, particularly:

- By securities regulators when monitoring financial markets through market surveillance;
- By banking supervisors ensuring that counterparty risk assessments are conducted to an adequate level;
- By authorities to monitor systemic counterparty risk; and
- By fostering cross jurisdictional collaboration between supervisors, both across the EU and with those outside the EU when these NBFIs are non-EU entities.

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 applicable

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?

To facilitate NCAs ability to effectively reconcile positions in leveraged products, it depends on the effectiveness of market surveillance:

- NCAs should get access to centralised data related to derivative markets (at least centrally cleared ones);
- For non-centrally cleared markets, banks report to the banking supervisors their counterparty risks – this facilitates the centralisation and consolidation of derivatives open positions. It is up to the supervisors to effectively use and assess this information received.

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?

ICMA is not commenting on the commodities markets questions as it's not within its area of expertise.

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 issue is not the links between banks and NBFIs, but how these exposures are monitored and mitigated when necessary.

It is up to securities regulators, to make sure they effectively apply MiFID and MAR obligations, when ensuring market surveillance; and it is up to banking supervisors to ensure that banks are adequately assessing their counterparty risks. In addition, appropriate monitoring by authorities is necessary to overcome the natural limitations of each bank's individual assessment and ensure these risks are effectively captured.

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?

An important benefit from an EU system-wide stress test would be the data that this exercise would provide and the specific interconnectedness between the various market participants. The success of the exercise will depend on the design of the test, sufficiently wide participation from market players and effective analysis from the results.

We are of the view that existing reporting and data sharing arrangements would not be sufficient to perform this task as the currently unmonitored NBFI players are not currently in scope. As mentioned in response to Q1, policy makers should prioritise increasing the data they collect on those types of NBFI players.

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

Yes – NBFI supervisors and banking supervisors must have an efficient communication strategy to determine how this data sharing could be effectively conducted.

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?

The most relevant example to comment on, is the Bank of England's System-wide Exploratory Scenario (SWES). If a similar exercise were to be adopted in the EU, there are certain conditions which should be met to ensure its effectiveness:

- System-wide tests should have a well-defined objective, focusing on how all market participants affect a specific market under a particular scenario.
- These tests should serve as information-gathering tools, not as a means to establish macroprudential policies for non-banks or to set prescriptive rules for individual firms (e.g. liquidity ratios or prudential requirements for banks).
- Supervisors should not make assumptions about market participant behaviour.
- Responses to scenarios should be based on participants' real-world experience, rather than hypothetical simulations created by supervisory authorities.
- It's important to acknowledge that each participant's behaviour and options will be influenced by their counterparties decisions and reactions, as well as policymaking and the regulatory framework they operate under. Understanding these interdependencies is crucial to make any accurate assessments.

If a system-wide stress test were to be conducted by EU supervisory authorities, it should be proportionate and have a defined time frame. Given the data and resource-intensive nature of these tests for firms, the proposal for annual testing may be disproportionate.

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)?

NBFIs that are part of banks do conduct stress tests at the bank "group" level, however within asset management firms, stress tests are not conducted at firm or "group" level because each fund is differentiated by numerous parameters such as their holdings, their client base and distribution strategy with net capital flows differing between funds. As mentioned in Q19, we advise against any specific measures assuming and targeting "cohorts of funds" as funds even within the same category experience market events differently. Each fund is differentiated by numerous parameters such as their holdings, their client base and distribution strategy with net capital flows differing between funds. Fund managers thus manage and react to each fund individually as risk cannot be measured at an aggregate level across a cohort of funds.

Therefore, an attempt for any "group", or firm level-stress test would result in wide disparities and contradictory conclusions that would not provide decision-useful information.

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.

We agree that a key factor to effective macroprudential policies is the consistent application of macroprudential tools and sufficient coordination among supervisors within the EU and supervisors in third countries. In order to ensure effective supervision, it is important that supervisors recognise and reflect in any consideration of reviewing macroprudential policies, the very heterogenous nature of the NBFI sector. The original macroprudential framework was specifically introduced to address new liquidity and capital buffer requirements for banks post GFC. Banks are more homogenous in nature in comparison to the NBFI sector and the regulations that govern banks can be applied, and banks can be supervised, in a more standardised approach. The heterogeneity of the NBFI ecosystem means that there cannot be a one size fits all approach, and the specific role that each EU body plays, needs to take into consideration each NBFI entity and activity separately to ensure effective supervision.

In the EU, there are several key regulations which outline the reporting obligations of asset managers and investment funds which cover reporting on AuM, leverage, risk exposures, liquidity, and transaction-specific data like derivatives and securities financing transaction. These reporting obligations are primarily governed by regulations such as AIFMD, UCITS, EMIR, MMFR, SFTR, MIFID II and other ECB- specific reporting frameworks (such as AnaCredit). Given the existing detailed level of reporting that asset managers and investment funds provide to their NCAs and other EU bodies, there is no lack of data as such concerning this specific sector of NBFIs.

Furthermore, it can even be considered that existing reporting requirements are unnecessarily overdemanding on some aspects. A gap analysis exercise will be necessary when ESMA will start working on amending the existing supervisory reporting for AIFs and introducing this type of reporting for UCITS. The objective should be to identify fruitless data on one side, and on the other side the cases where further detail may be needed. It will be key to engage the industry in this analysis exercise to ensure that the most relevant data is selected and to avoid any unnecessary reporting requirements.

Finally, greater coordination between supervisors could be facilitated by ensuring that there is a focus on improving data sharing between the various EU bodies.

The immediate issue to address is thus:

1. **Effective data sharing between EU bodies of the data** that is already received would facilitate EU bodies to identify and mitigate any potential vulnerabilities.
2. **Identify the data gaps within the NBFI entities and activities** which may be a source of systemic risk and where reporting obligations may need to be enhanced.

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?

We acknowledge that the existing coordination mechanisms have demonstrated their effectiveness in some cases. This was more recently demonstrated by the Central Bank of Ireland (CBI) when they used Article 25 of the AIFMD in two notable instances:

- For Irish real estate funds in 2022
- For GBP LDI funds in 2024

The GBP LDI fund action was taken in coordination with Luxembourg's CSSF and is an example of a successful coordinated effort to address cross-border risks.

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 described in previous questions, we are very supportive of enhancing the efficiency of the current supervisory framework through greater facilitation of supervisory coordination.

We consider that instead of introducing an ECM, there should be greater focus on facilitating data sharing between the NCA and the ESAs and how this could also lead to streamlining of existing requirements by NCAs. This could be achieved **via the creation of a single regulatory reporting data hub,** where NCAs and ESAs have access to relevant data sets, and on an aggregated basis where required, on the data which is already being collected via the different reporting requirements. Especially given the recent AIFM and UCITS Directives reviews which enhanced reporting requirements (including the requirement for ESMA to develop new reporting templates), it is a timely opportunity to upgrade Europe's data collection infrastructure and sharing mechanisms. This single data hub mechanism has also been proposed by several key EU NCAs[33]. This should also allow to remove existing differences between requirements by NCAs, leading to duplication of obligations that are currently enforced in different ways at national level while referring to the same EU rules.

Regarding the proposed ECM, we do not consider that the proposal enhances supervisory coordination due to a number of considerations:

Preserving existing supervisory centres of excellence:

It is important that the existing supervisory centres of excellence are preserved. Asset managers, investment funds, and ultimately the end investors, greatly benefit from the deep, specialised expertise that local NCAs have fostered thanks to their experience in authorising and regulating a diversity of funds. This expertise, and the relationships that have been built between the supervisor and the regulated firms, enables greater oversight of complex financial products and risk management practices. These supervisory centres of excellence are ultimately best-positioned to identify and address any risks related to market stability and investor protection.

Uniform list of national macroprudential measures (NMMs): We also have reservations on the viability of the creation of a list of national macroprudential measures (NMMs) that could be applied uniformly to all OEFs across all (or a subset) of EU member states given the different jurisdictional considerations. An NMM may be appropriate, and specific, to only one jurisdiction and not relevant to another (for example when leverage limits were enforced for Irish real estate funds in 2022).

The proposed ECM thus risks limiting NCAs in implementing measures that are tailored to their specific national circumstances and domestic fund structures and slow down decision-making processes, reducing their ability to respond swiftly to domestic issues and acting in the best interest of the investors. As described in Q58, there are cases where some measures may be relevant for implementation across multiple jurisdictions and NCAs have successfully demonstrated their existing capacity to take effective coordinated action, on some specific cases, as was demonstrated in March 2024 when the CBI and CSSF coordinated actions on imposing leverage limits on GBP LDI Funds. This coordination was supported by ESMA.

33 position-paper-a-macro-prudential-approach-to-asset-management_0.pdf

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?

As described in Q59, we consider that ESMA already works very effectively with NCAs in facilitating and advising on coordinated action on measures that are of relevance to other EU countries. Moreover, the recent AIFMD and UCITS Directive review is ensuring that LMTs will now be more widely available across the EU, and also facilitate greater cooperation between home and host regulators on implementation of certain measures with ESMA playing an advisory role. As LMTs will be harmonised and available for all AIF and UCITS funds across the EU, we do not consider any extra measures necessary.

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.

See our response to Q60.

Supervisory powers of EU bodies

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

We are concerned that the question as drafted assumes that the size of the asset management company is related, or in any way proportionate, to the size of the market risk they may pose. Size is not an appropriate risk metric, or an indicator of potential future liquidity shocks such as from margin calls related to derivatives positions. Applying different rules to entities depending on size would create an unlevel playing field and risks regulatory arbitrage.

An example of a failure of supervising entities differently depending on size, is the 2018 rollback of certain Dodd-Frank ACT provisions which reduced regulatory oversight for banks with assets below USD 250 billion. This deregulation exempted banks with assets below USD 250 billion from stress tests and tougher capital and liquidity requirements[34]. One of the banks which benefited from this exemption was SVB, which resulted in being the largest bank failure since the GFC.

Ultimately, **supervision should be applied consistently across all management companies and not be determined by size.**

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 see response to Q62. We do not consider there to be a need for any additional, or distinct, powers, to supervise large asset management companies.

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)?

We do not consider that there any benefits in having targeted coordinated direct intervention powers to manage crises as NCAs already have direct intervention powers, applicable to EU funds and their managers, as well as coordination obligations (which were enhanced in the recent AIFM/UCITS Directives review).

Other NBFIs and markets

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

No comment.

34 Why did Silicon Valley Bank fail? - Economics Observatory

ESAs and ESRB's powers during emergency situations

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

As highlighted in response to Q58 and Q64, we do not consider there to be any additional benefits for intervention powers to be strengthened, vis-à-vis NCAs, or extended, vis-à-vis ESMA.

NCAs already have direct intervention powers which have recently been further enhanced by the revised AIFM and UCITS Directives. Asset managers and the fund governing boards, have the deepest understanding of investor profiles, liquidity profiles and fund holdings and are best placed to make decisions in the best interest of investors – their decided course of action is based on their fiduciary duty and it risks being undermined if ESAs are given more intervention powers which may negatively impact the fund.

Ultimately, fund managers are best placed to manage liquidity risk and any NCA intervention should remain a last resort measure, following discussion with the fund manager and consideration of any proposed intervention impact on the fund and its investors.

The priority should be to improve the feedback mechanism on the reported data between the ESAs to facilitate more informed, and coordinated discussions, in times of crisis. This could be addressed via the creation of a single regulatory reporting hub.

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?

ICMA is not commenting on the commodities markets questions as it's not within its area of expertise.

International coordination

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

We do not consider that there are particular elements of the FSB NBFI programme that should be prioritised in the EU as the EU has recently greatly enhanced its existing regulatory frameworks.

The EU should focus on:

- Supporting securities regulators in enhancing their market surveillance, as this practice allows them to receive information, directly and indirectly, on all NBFIs.
- Supporting banking supervisors in facilitating existing CRR/CRD. These obligations are complimentary to the existing supervisors market surveillance practices, and further facilitate the monitoring of different types of NBFIs.
- Facilitate the ability to effectively share data between ESMA, NCAs and the central banks, via a single regulatory reporting hub, which will help identify regulatory gaps, support in developing targeted policy responses and enable a more holistic view of players in the market.

Financial stability and interconnectedness is broader than just looking in isolation at banks or NBFIs, the review and analysis should consider the entire "eco-system" and not lead to increased regulation for a specific sector.

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